M&A – A Primer

While the IPO market has improved since 2001, the vast majority of exits for startup technology companies involve acquisitions. The bar for going public has been raised due to Sarbanes-Oxley and other public company expenses and many executives indicate that being a public company senior executive has become less fun. In addition, with many OEMs consolidating their supplier bases, it is often difficult for startups to gain traction with top-tier customers, regardless of how good their technology is. As a result, the level of technology M&A deals will likely continue to accelerate over the next several years. This article provides a brief overview of the M&A process and related terminology.

The M&A Process

No two acquisitions are identical and the process can vary significantly from deal to deal. However, in order to provide a general idea of the M&A process, this section summarizes the major steps from the point of view of a private technology company (Techco) that has decided to make itself available for purchase.

Engaging an Investment Bank - When a company begins to consider selling itself, it will typically engage an investment bank. An investment bank will provide advice on timing and positioning, and will generally have relationships with key executives at the prospective buyers. Techco should seek an investment bank that has extensive M&A experience in its particular technology sector. Once Techco has decided on a particular investment bank, it will sign an engagement letter. The engagement letter should not in any way obligate Techco to sell, but should merely indicate that the investment bank will assist Techco in the process and detail the investment bank's fee structure.

Formal Or Informal Process - Once an investment bank is engaged, it will work with Techco's management to determine the best process for approaching potential acquirers. In some cases a formal process will be used in which a large number of prospective acquirers are contacted at about the same time. In other cases, it may be preferable to use an informal process, which could encompass a wide range of different strategies.

Positioning Material & Buyers List – Assuming a formal process is used, the investment bank will work with Techco's management to develop an information memorandum that summarizes Techco's business (markets, products, customers, financials, etc.). It will also assemble a list of prospective acquirers.

Contact With Potential Acquirers - Next, the investment bank will begin contacting prospective acquirers and sending them copies of the information memorandum. All of the prospective acquirers might be contacted at about the same time, but more often they are contacted in tiers. The general goal is to have as many interested parties as possible engaged at about the same time.

Meetings and Follow-On Meetings - After holding discussions with many of the prospective acquirers, the investment bank will arrange meetings between Techco's management and key executives from the prospective acquirers. After the initial screening meetings, interested parties will generally want to have follow-on meetings with Techco management to further delve into the technology or financials.

Term Sheets Submitted - At some point, interested prospective acquirers will submit preliminary offers, typically in the form of a proposed letter of intent (LOI), which is also often referred to as a term sheet. An LOI can be thought of as a preliminary version of the more detailed final acquisition agreement. It includes the amount the prospective acquirer is offering as well as some of the anticipated basic terms of the acquisition. By submitting a proposed LOI, a prospective acquirer indicates his interest in pursuing further negotiations. However, the document is typically non-binding (aside from confidentiality and exclusivity clauses) and generally does not create any obligation for the prospective acquirer.

Detailed Negotiations/Due Diligence - Once term sheets are received, more detailed negotiations begin with the interested prospective acquirers. At some point, Techco may decide that it is interested in accepting an offer from one of the prospective acquirers (e.g., BigTech). Once this happens, Techco will typically agree to an exclusivity (no-shop) period during which time it ceases to negotiate with other prospective acquirers and works on finalizing the details of the transaction with BigTech. During this period, BigTech performs more detailed due diligence on Techco.

Final Acquisition Agreement - Either during or upon completion of the prospective acquirer's due diligence, both parties focus on finalizing the acquisition agreement, which is a binding document. In addition to including the terms of the acquisition, the acquisition agreement also includes conditions for closing (what events must occur before the deal can be closed) and other provisions.

Closing - After an acquisition agreement is signed, both parties work towards completing the conditions for closing. Depending on the terms and structure of the acquisition, this might include: obtaining shareholder approvals, issuing new stock, assigning customer/vendor contracts, and obtaining government approval. Shortly after all of the conditions to close are satisfied, the parties generally meet to complete the final paperwork. The appropriate consideration is transferred and the deal is closed. In less complex transactions involving non-public targets, it is sometimes possible to sign and close the transaction simultaneously.

Acquisition Agreement Overview

While every contract is different, the following are the major portions of a typical acquisition agreement:

Deal Overview & Consideration – The initial sections of the agreement provide an overview of the acquisition, including the acquisition structure, the type of consideration provided (consideration refers to the compensation, such as stock or cash, paid to the target's shareholders), and the procedure to complete the deal.

Representations & Warranties – Reps and warranties refer to statements about the current state of a company's business and the expected state of the business at the time of closing. While most contracts include reps and warranties for both the acquirer and target, the focus is generally on the target's business.

Covenants – Covenants are promises that certain acts will be performed and others avoided. Although most contracts include both acquirer and target covenants, the primary focus is to ensure that the target (Techco) will continue to run its business in an appropriate manner between the time the acquisition agreement is signed and the deal closes.

Conditions for Closing – This section includes details on what actions must occur before the transaction can be completed.

Termination Provisions – This section lists the circumstances under which each party can decide to terminate the deal before closing. For example, some contracts may include a material adverse effect (MAE) clause which allows the acquirer to cancel the deal if there is a significant negative change to the target's business before the deal closes.

Indemnities and Escrow – If one party breaches the contract, the other may be entitled to remedies. This section of the agreement specifies the circumstances as to how the injured party will be reimbursed. To facilitate this, a portion of the consideration is typically held in an escrow account and released to shareholders only after the indemnification period ends.

Some Key M&A/Negotiating Terms

Some key terms and general negotiating points that often arise in acquisition agreements are listed below.

Fixed/Floating Exchange Ratios – When stock is used for an acquisition, one issue is that the value of publicly traded stock can change between the time a deal is announced and when it closes. As such, there are a number of ways this type of consideration can be specified. With a fixed exchange ratio, the acquirer agrees to pay a fixed number of shares for each share of the target. However, the value of those shares can change based on changes in the acquirer's stock price. With a fixed value (floating exchange ratio) arrangement, a fixed dollar amount of stock is specified (e.g., $100 million). In this case, the value is fixed but the number of shares the acquirer has to provide varies based on the value of its stock. Acquisition agreements often include floors or caps, which provide minimum and maximum limits on how much the value or exchange ratio can vary. When both a floor and a cap are specified, it is referred to as a collar.

Acquisition Structure – Although the terms mergers and acquisitions are often used interchangeably by the general public, legally the terms have different meanings. There are three general methods by which one company can acquire another: a merger (Techco legally merges into BigTech, Techco no longer exists), a stock acquisition (BigTech purchases a majority of Techco's stock from its shareholders), or an asset purchase (BigTech buys the assets of Techco). There are also dozens of variations on these basic categories. Triangular mergers, in which the acquirer creates a subsidiary which then merges with the target, are particularly popular. Each of these structures has significant ramifications in terms of taxes, timing, and liability assumption.

Walk Away or Out Provision - Some contracts may include a walk-away or out provision enabling one party to walk away from a deal before closing if the stock price of one of the parties changes by a specified amount before closing.

Earn-Outs - One feature that has become more popular in acquisitions of private companies is earn-outs. With an earn-out, some portion of the acquisition consideration is contingent upon the target meeting certain goals generally over a specified timeframe. For example, BigTech might agree to acquire Techco for $60 million with the potential for an additional $15 million based on Techco reaching certain goals after closing.

Employment Agreements & Retention - Employee agreements are an important part of an acquisition agreement. These may include stipulations that all or some portion of the target's employees will be guaranteed employment for some period after the deal closes and whether the acquirer will set aside a specific amount for retention bonuses.

Escrow/Holdback - In many private company acquisition agreements, some portion of the consideration (typically 10%-20%) is set aside and paid out to the target's shareholders only after a specified time period. If it is determined that some of the representations and warranties made by Techco were not accurate, BigTech may be entitled to compensation from Techco's shareholders, which would be hard to collect after all the consideration is distributed.

Indemnity Basket - To prevent the acquirer from making indemnity claims for minor items, an acquisition agreement will often include an indemnity basket. This is a minimum level of indemnity claims that must be reached before the acquirer can pursue collecting compensation.

International M&A

One clear trend is the growing number of cross-border technology acquisitions. Cross-border transactions add an additional level of complexity, as acquisition structures, tax laws, and contract law differ among countries. For example, India (as well many other countries) does not have laws that provide for mergers. So transactions in India must be structured as stock purchases or asset acquisitions. Some countries have provisions requiring the parties to negotiate in good faith. As a result, what is considered good negotiating tactics in one country (e.g., implying there is another bidder offering a higher price when there is not) may be prohibited in other countries. It is important to recognize that acquisition rules can substantially vary outside the U.S.

Valuation

Probably the most important topic to any potential seller is valuation. Three commonly used methods for predicting valuation levels are evaluating comparable M&A deals, examining related public company valuations, and performing a discounted cash flow analysis. However, the actual value of a transaction depends upon many factors and can often substantially differ from levels predicted using the previously mentioned methods. As with any other type of auction, valuation is ultimately determined by how much buyers are willing to pay, and this can be difficult to forecast. In general, the single most important factor in increasing valuation is having multiple parties interested in the target company at the same time. This is why running an acquisition process in the appropriate manner is critical to maximize valuation.

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