How to Navigate the Transforming Deal Landscape

By Curtis Farrow, Manager, Pine Hill Group LLC Valuation Services and Joe Kadlec, Partner, Pepper Hamilton LLP

This article was based on an interview with Tom Terrarosa, Senior Reporter, The Deal

While far from a new trend, deal valuations are producing high expectations for sellers across industries, which is driving a transformation in the dealmaking process.

With tax reform leading to greater profitability for companies and an ever-increasing level of dry powder on the sidelines waiting to be deployed, this transformation can only be expected to accelerate further in the coming years.

"It has long been a big question whether the expectations of sellers and buyers could align," Pepper Hamilton LLP partner Joe Kadlec told The Deal in a recent interview. "In the past few years, we've seen buyers try to bridge the gap through things such as reps and warranties insurance. This is relatively new (over the last five years), but is picking up a lot of steam, and in a competitive process, you're seeing it in almost every deal at this point." Usage of this insurance has grown aggressively and the terms of such policies are evolving to provide more of a walk-away transaction and broader coverage. The product has also started to be used in certain other business deals that had been no-indemnity transactions historically.

Kadlec explained that the speed of deals in competitive processes has also intensified. Where typical processes may have included exclusivity periods between 60 days and 120 days, competitive auctions are now seeing exclusivity periods dwindled down to 30 days or often less (or even no) exclusivity, giving buyers a more stringent timeline in which to build their best offer.

Other components of the private company, middle-market dealmaking process, such as consideration for private equity fund rollovers or the trend of less indemnity exposure or lower closing condition standards, also are having an effect. As these trends move down-market and become commonplace, the power dynamic has once again shifted toward sellers, Kadlec added.

"So these were trends, and unique ways to distinguish yourself," he said. "They're not anymore. Now they're pre-requisites for a deal in a competitive process. So, it has seemed recently that we're back to the same world where price drives everything. But sellers still have a lot of leverage. And so, they're using that to push for other things, as well."

In a seller's market, deal advisers like Pepper Hamilton's Kadlec find themselves in a uniquely challenging position.

"Nowadays, if someone tells me we have 30 days to do a deal [after the bid], that sounds like plenty of time," Kadlec said. "It's funny how that's changed. The expectations on how much work is getting done prior to exclusivity have changed. It might be the expectation that there's just no more diligence to be done once a bid has reached the point of signing a letter of intent. We're off to the races, no more diligence to be done.

"And so, there's a lot more work in the earlier stages that affects the lawyers," he continued. "We have to prioritize our diligence, be efficient, focus on the things that are actually deal drivers, and not confirmatory points. Those will come later. The deal teams on the business side are doing the same. They're focusing on what's really going to drive this deal. What's really driving the price. And the confirmatory points will come after."

Even as buyers come to grips with the fact that the price will be the primary deciding factor, sellers are testing how far they can push the limits on what potential suitors will also be willing to give up, Kadlec explained.

"What that means is, a deal could include reps and warranties insurance, but now there is no deductible for the seller to bear; the buyer [and the insurer] is on the hook for every penny," he said. "Sellers may even say that taxes aren't something they want to be on the hook for."

All of this for advisers means narrowing the focus and cutting to the chase, Kadlec added.

"What I mean by that is, in a competitive process, we're trying to do this quickly, so more and more buyers are serving a more middle-of-the-road, or even a seller-friendly, draft of a purchase agreement from the start," he said. "We're just getting right to the point so we can get the deal done."

But speed is not necessarily a bad thing for buyers, Kadlec said, as there can be risk on the buy-side if a deal drags on too long. Deal work tends to distract from the day-to-day business and can be a drag on the business even post-closing.

Moreover, there are things buyers can still rely on during deal processes.

"Most importantly, I think even with reps and warranties insurance, even with the speed that deals are happening, the diligence still needs to be done," Kadlec explained. "Even though there may be an insurance policy backing everything up, it has a cap. You don't want to be buying an asset where you only are protected for 10% of the purchase price, or 20%. So, you still have to do your diligence. Furthermore, known issues are not going to be covered by insurance. So, if that affects the purchase price, or if it's just pure planning purposes, you need to be ready for it.

"And then, really the last point, a higher price is going to affect your modeling," he continued. "I think the deal community certainly understands that, and probably more than the lawyers, of course. But that goes into the modeling, and where the exit is headed, down the road."

Decision making is far from over for buyers when the deal closes, however, according to Curtis Farrow, a Pine Hill Group business valuation manager who joined Pepper Hamilton's Kadlec in an interview with The Deal this fall. The higher prices still need to be factored in and valued, and the key factors for post-close value creation still hold true.

"Farrow explained that during the purchase price allocation process, an opening balance sheet of the new company is created whereby the fair value of the purchase consideration is allocated across the various assets that are acquired. The fair value of the purchase consideration is also determined during the purchase price allocation process. This is when factors such as rollover equity and earnouts come into play.

"The purchase consideration is very straightforward if it's an all cash deal; there's really no valuation to be had there," Farrow explained. "But in a lot of deals, particularly with private equity firms in a platform deal, often we see the sellers want to stay on, and they want them to be incentivized to drive future value."

It's important, though, for buyers and sellers to be aligned ahead of a deal's close on what the value of the consideration is for the rollover equity.

"We've seen a lot of issues when we have to go in there and value what the sellers actually got when there are multiple classes of stock,' Farrow said. "That's a very common thing with private equity deals."

Private equity firms often take preferred stock in a business. As such, on the exit of that business, the firm will usually get their money back, plus a return on that money by way of an accrued dividend or other preference before the rollover investors are able to participate in the sale proceeds.

"So, the headline price on a deal isn't necessarily the per share value that the sellers are going to get," Farrow added. "And there's nothing wrong with that. It's a way for the buyer to mitigate some of its risk. But it's important that it's communicated up front, so that you're really doing what your intent is with the rollover equity, incentivizing the management team."

Another consideration valued during the post-close process is earnouts, which are payments beyond the up-front consideration that will be paid to the seller upon different milestones, such as EBITDA or revenue growth.

"Often buyers and sellers go in with an expectation of 'What's really the true value of earnouts? Is this such a high hurdle, that if they hit it, it would be a home run, so to speak," Farrow said. "Other times, it's really baked in, where unless things go really south, they're most likely going to hit the milestone."

But in the accounting exercise, anything and everything is far from certain, Farrow added.

"So, usually it's not an all or nothing," he explained. "It's somewhere in between that full value of what the potential consideration is, and that gets hammered out in the valuation process that unfolds."

For more information on how Pine Hill can help you navigate the dealmaking process, contact Curtis Farrow at 215.391.4321 or cfarrow@pinehill.com