M&A Risk Management

2015

Introduction

- M&A may provide companies with an opportunity to grow, capture synergies, or accomplish other strategic objectives that can create value …

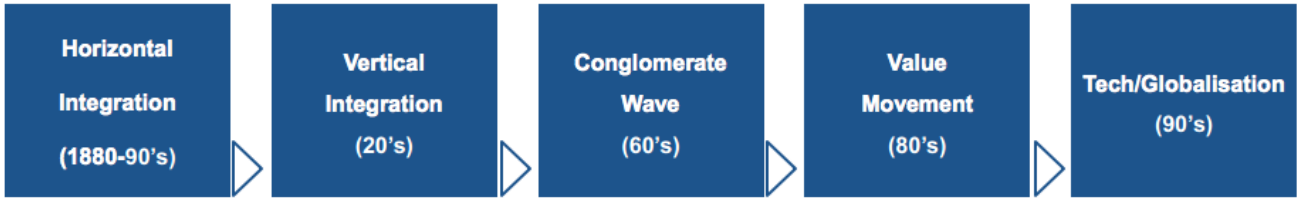
- … but **most transactions fail to accomplish their stated objectives**, because – among others:
  - Incorrect **valuation**
  - Adverse changes in the **economy** after the deal closes
  - Failure to capture **synergies**
  - Inefficient post-merger **integration**

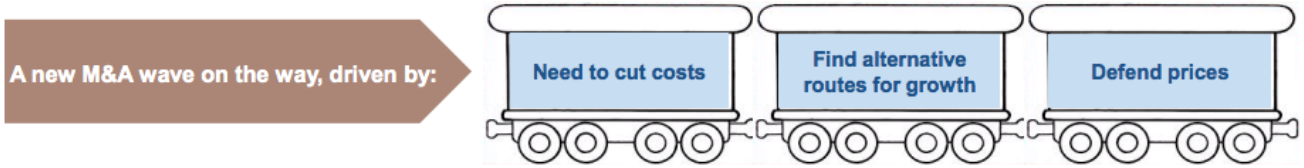
- Performance depends on an acquiring board's ability to evaluate, plan for, and manage risk in all stages of the transaction

- Effective **risk management** requires the board to
  - Accurately **value** a target
  - Account for **factors** that increase the likelihood of **failure**
  - Shape a merger plan that supports efficient **integration** and **synergy** capture

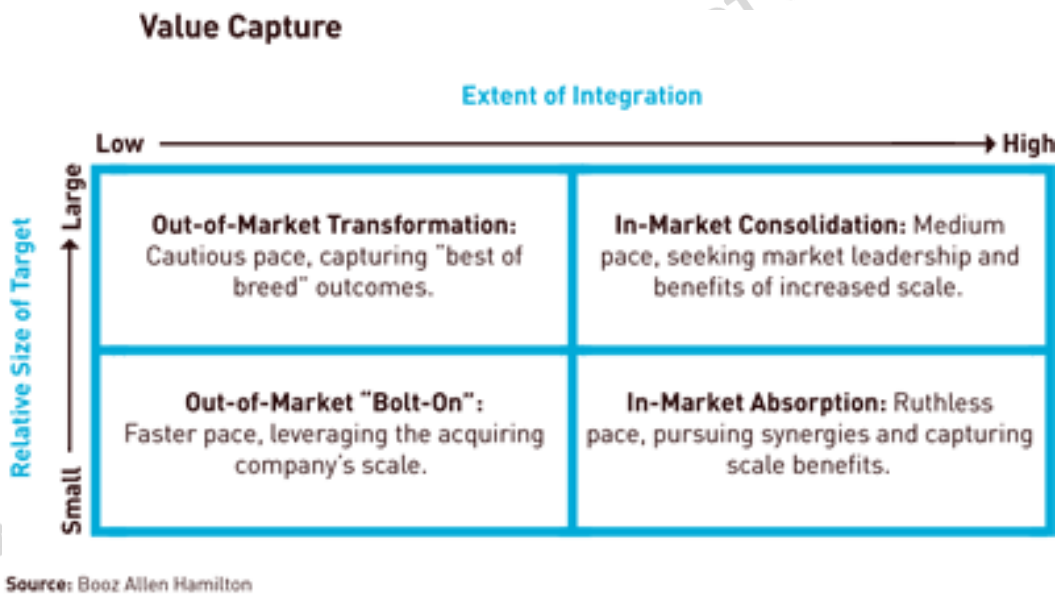
M&A Waves

Five previous waves, and as many reasons





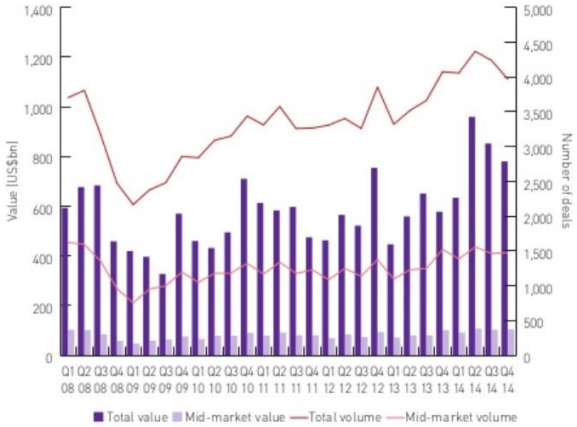
M&A Value Capture



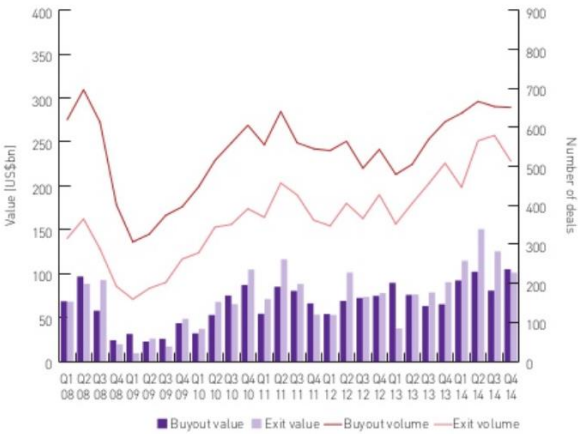
M&A Destroys Value

- About **half of M&A transactions fail to accomplish the objectives** stated when the deal is announced
- An estimated **67-75% of M&A transactions fail to create additional value**
- Historically, **acquiring companies** have experienced a **drop in share price** after plans for a deal are made public

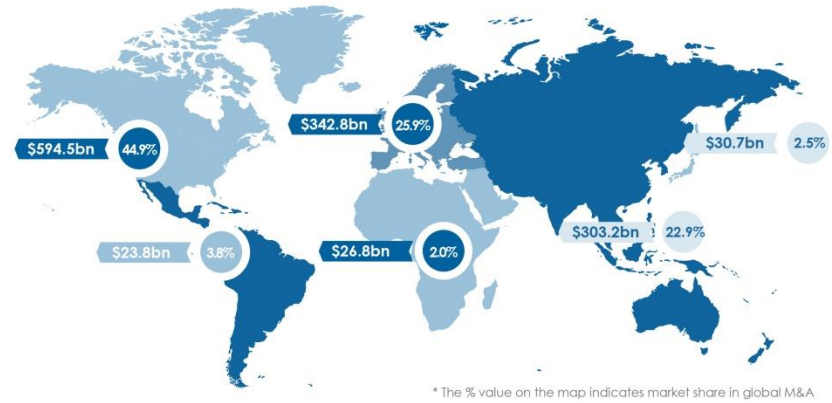
GLOBAL M&A QUARTERLY TREND



GLOBAL M&A QUARTERLY PRIVATE EQUITY TREND



Global M&A 1H2016



Global M&A

$1.32tn, -26.8% vs. H1 2015

Cross-border	$550.8bn	↓ 15.9%
Industrials & Chemicals	$244.0bn	↑ 51.0%

US

$562.7bn, -31.5% vs. H1 2015

Inbound	$167.9bn	↓ 13.8%
Outbound	$82.8bn	↓ 21.7%
Pharma, Medical & Biotech	$109.3bn	↓ 23.6%

Europe

$342.8bn, -19.3% vs. H1 2015

Inbound	$166.2bn	↑ 14.8%
Outbound	$85.5bn	↓ 2.9%
Industrials & Chemicals	$107.7bn	↑ 126.8%

Asia-Pacific (excl. Japan)

$303.2bn, -30.7% vs. H1 2015

Inbound	$33.9bn	↓ 32.7%
Outbound	$134.7bn	↑ 70.3%
Technology	$53.3bn	↑ 22.0%

C & S America

$23.8bn, 0.6% vs. H1 2015

Inbound	$14.4bn	↑ 13.5%
Outbound	$10.4bn	↑ 215.8%
Energy, Mining & Utilities	$10.3bn	↑ 117.4%

Africa & Middle East

$26.8bn, 50.8% vs. H1 2015

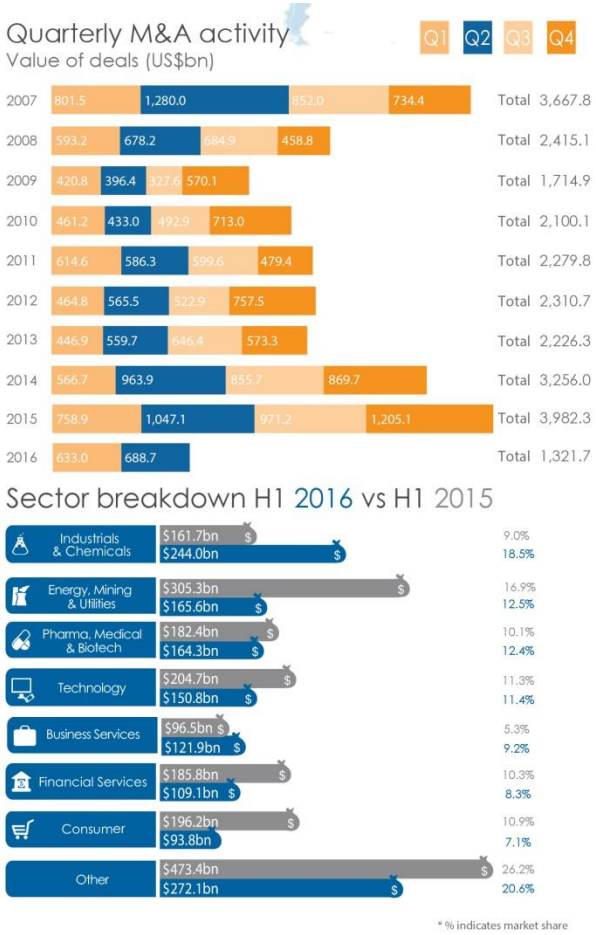
Inbound	$18.8bn	↑ 27.3%
Outbound	$8.4bn	↓ 62.6%
Consumer	$11.9bn	↑ 1,463.3%

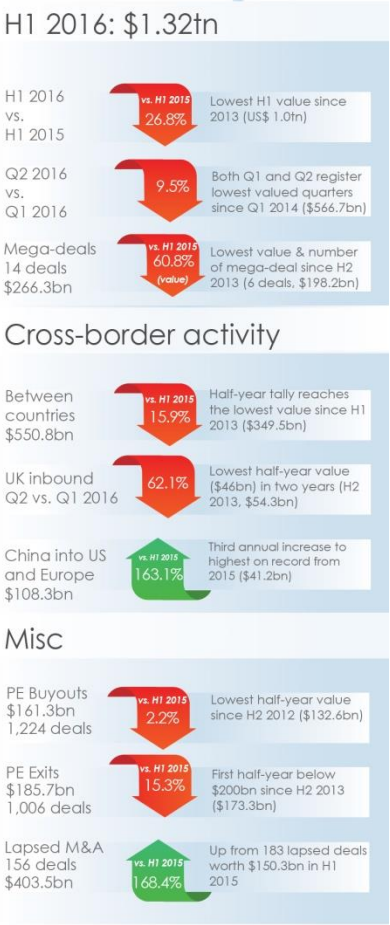
Japan

$30.7bn, 67.8% vs. H1 2015

Inbound	$3.5bn	↓ 17.6%
Outbound	$30.7bn	↑ 67.8%
Industrials & Chemicals	$9.7bn	↑ 142.6%

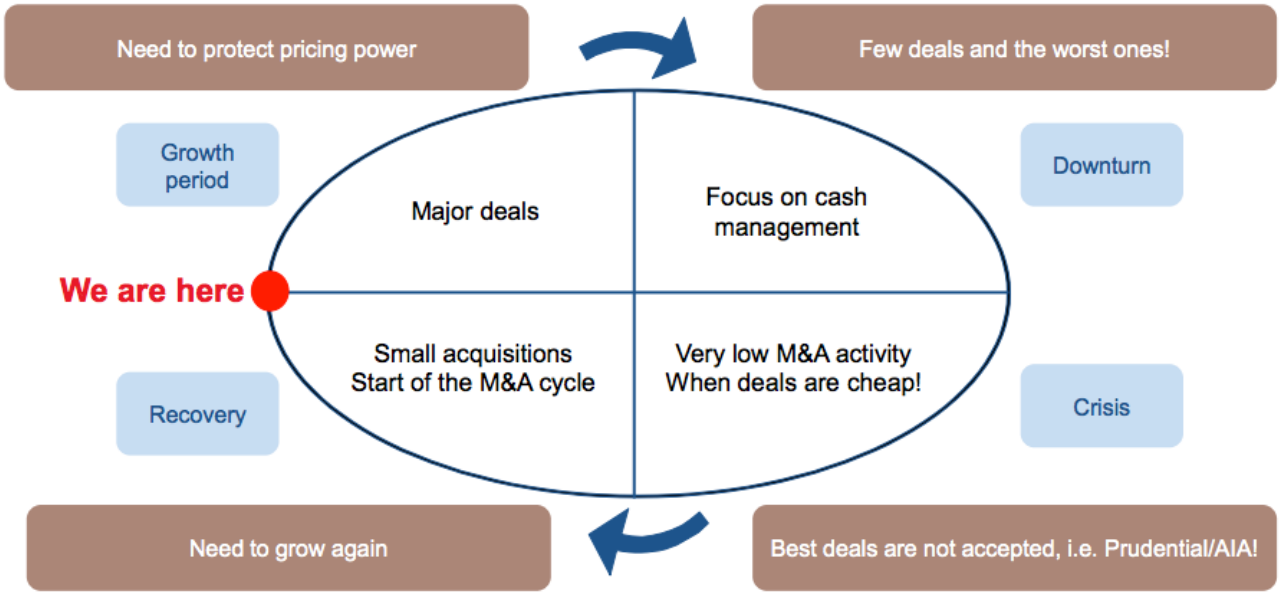
Global M&A 1H2016 (cont´d)





M&A Destroys Value (cont´d)

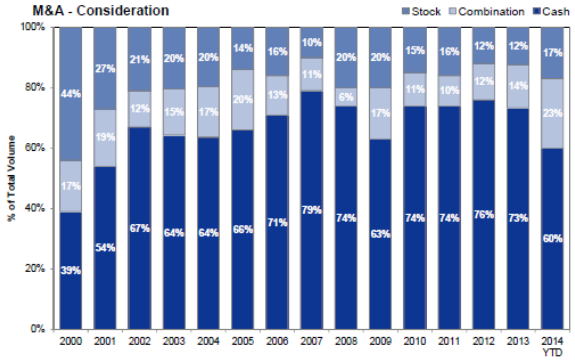
THE M&A CYCLE AND ITS POOR TIMING



Acquisition Currencies

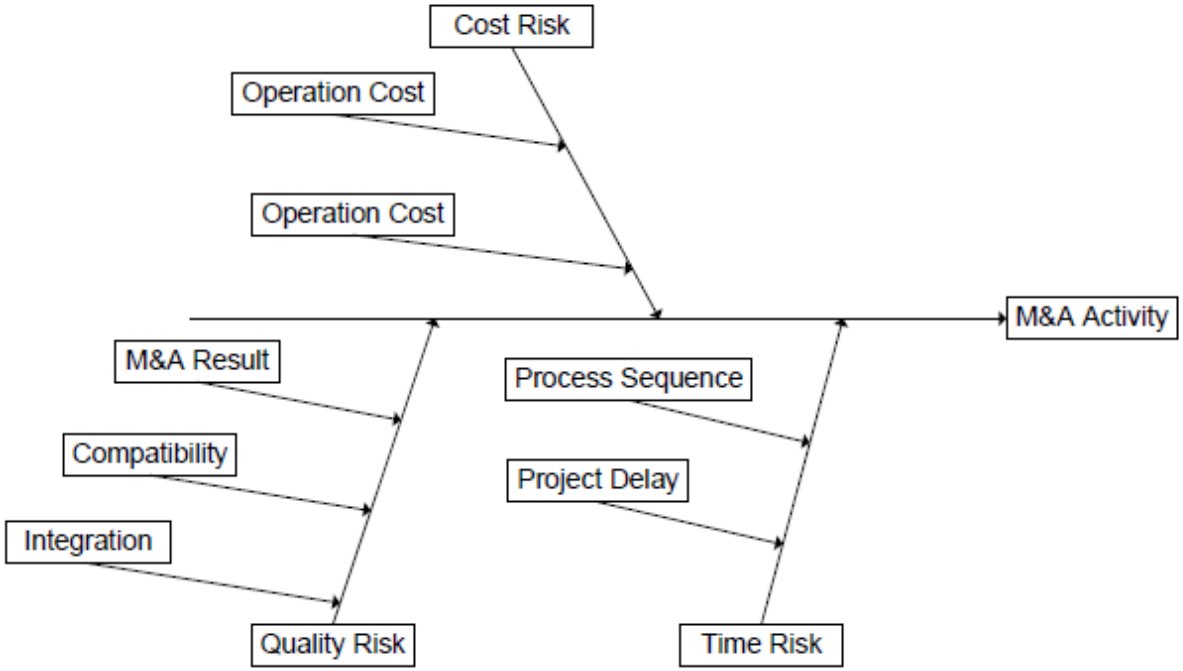
- By paying with stock, acquirers may overpay if their stock is undervalued..
- … while rising stock prices may mitigate this risk

: Consideration paid in stock, cash, and a combination
as of June 13, 2014



Source: Thomson Reuters / SDC and Goldman Sachs Global Investment Research.

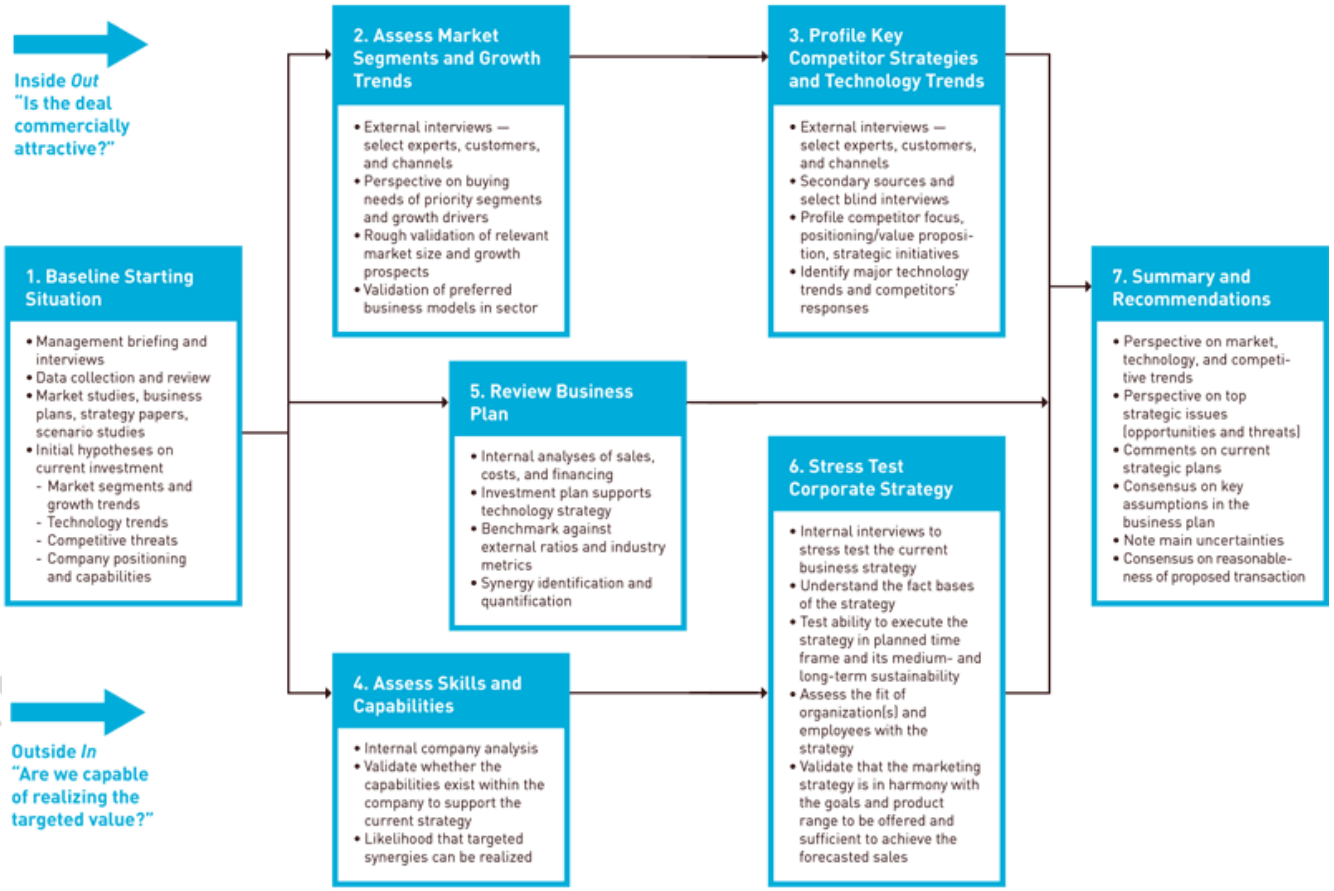
A Fish Bone Scheme of Risk



Strategic Due Diligence Methodology

- The first question, testing the commercial attractiveness of a deal, involves validating both the target's financial projections and any identified synergies using an *external* lens
- As for the second question, a company must make a hard *internal* examination of whether the targeted value of the deal can be realized by the management team of the combined enterprise, and, if so, whether the projected time frame is realistic

: Strategic Due Diligence Methodology



Source: Booz Allen Hamilton

Due diligence: Main steps

Preparation

- Due diligence team
- Outside expertise as necessary
- Early involvement of the the integration manager
- Due diligence checklists
- Data requests
- Confidentiality agreement
- Physical or online data room for confidential documents
- Communication plan

Due diligence is one of several steps in a holistic M&A process.

Due diligence: Main steps (cont´d)

The scope of a due diligence may be **less extensive** if all of the following are true:

- The target company is **financially strong**
- The target is willing to give **extensive representations** and warranties and indemnities
- Those **representations** and warranties and indemnities **survive closing**
- The **selling entity** is **creditworthy** and survives closing
- The transaction is an **asset purchase** with only understood liabilities being assumed (and no successor liability concerns)

Any of the following considerations require to **ramp up** the scope of due diligence:

- The target is not strong financially
- The target is not willing to give extensive representations and warranties and indemnities
- Representations and warranties and indemnities don't survive closing
- There is no creditworthy surviving entity or shareholder after closing
- There is a very small margin for error
- The transaction is a stock purchase or merger or an asset purchase with broad liabilities being assumed (or there are successor liability concerns)

Due diligence: Main steps (cont´d)

Execution

Due diligence is not a negotiation; it's a fact-finding mission, and after a company submits its letter of intent those facts start coming in fast and heavy...

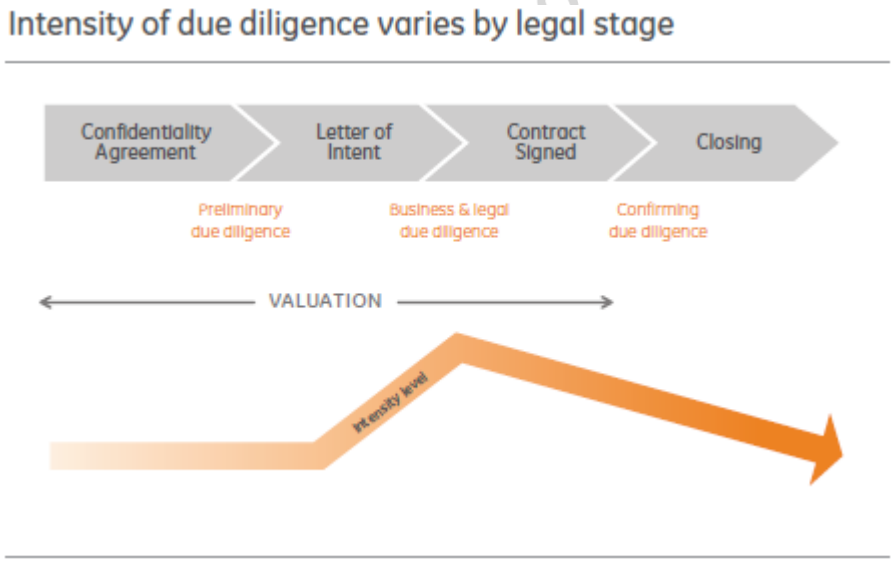
- Do the target's **financial statements accurately reflect** the company's financial condition?
- Would the **integration** of your operations with those of the target have any **adverse effect on profitability**?
- What is the target **company's outlook** in terms of its customer base and concentration, its competitive positioning, and its ability to **preserve or increase its margins**?
- Is the target company exposed to any significant and unexpected **regulatory, governance, or liability risks**?
- Are there any issues associated with **long-term sustainability** (e.g., availability of raw materials, environmental factors) that could affect the target's future **operations**?
- Have **future costs** (for example, underfunded pension liabilities) been figured into the acquisition value?
- What is the **quality** of the company's **management** team?
- Who are the target's key, value-creating **employees**, and what's the outlook for **retaining** them?
- Are there any clashes of **corporate culture** that could adversely affect
- If the M&A is **cross-border**, are there cultural, legal, tax, accounting, employment, merger-control, corruption, or environmental challenges that will present real roadblocks to the deal?)

Due diligence: Main steps (cont´d)

Common due diligence mistakes

- Examiners may **misidentify** the **risks** associated with the acquisition
- Examiners may get so focused on their individual functions that they **miss the big picture**
- They may **overlook the "soft"** but important element of the target's corporate **culture**
- Team members may disclose expected synergies with the target company (leading them to, for example, increase their asking price to capture that value)
- The team may **rely solely on virtual due diligence**, and never put boots on the ground
- The team may be so focused on spotting risks that they **overlook opportunities**
- Executives may be so in love with the deal that they ignore risks identified in due diligence and move ahead anyway

Due diligence: Main steps (cont´d)

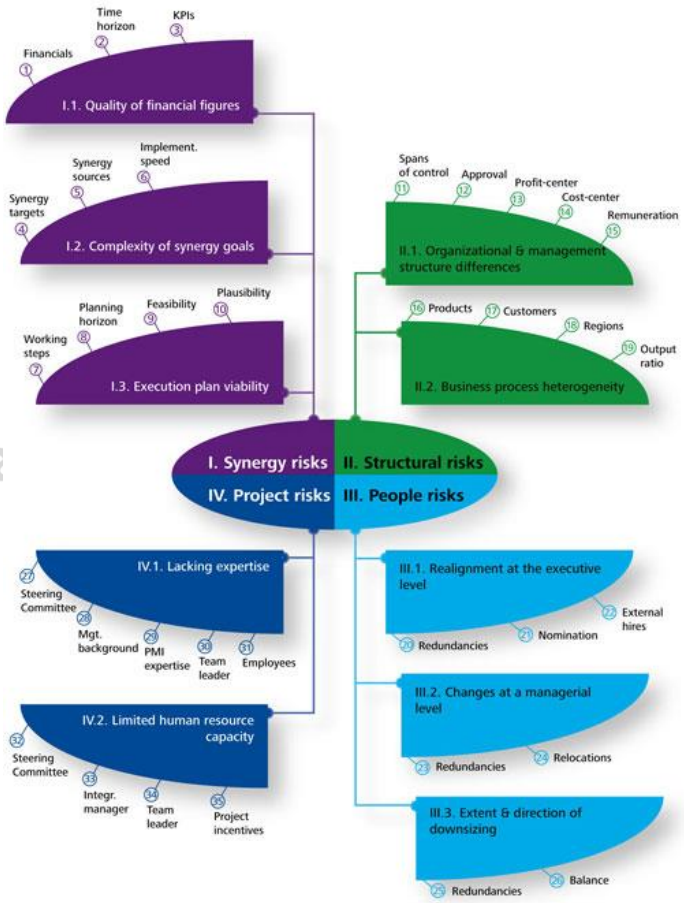


Post-Merger Integration Risk and Merger Success Rate

- Regardless of the economic forecast, the type of currency used to acquire a target, or the value a deal can potentially create, …
- … optimal deal performance is ultimately a function of a company's **ability to preserve value after the deal closes**

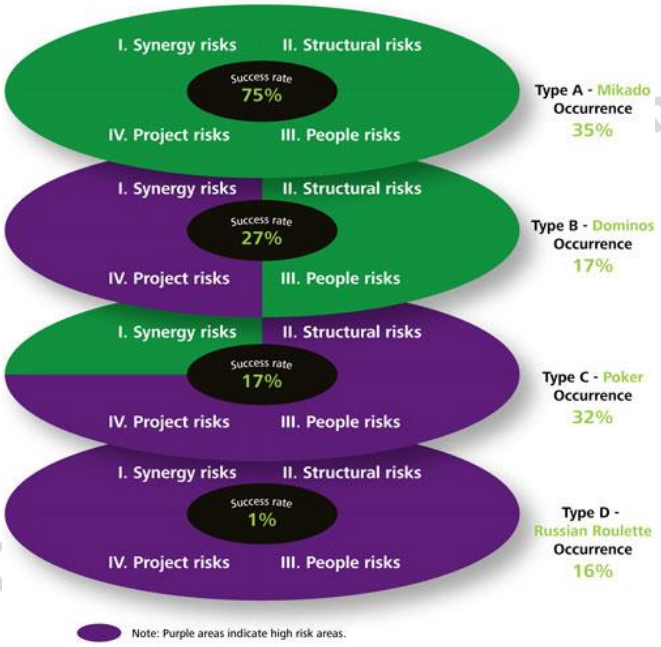
Post-Merger Integration Risk and Merger Success Rate (cont´d)

- **There are only around 35 factors within four categories to be statistically significant in influencing PMI success**



Post-Merger Integration Risk and Merger Success Rate (cont´d)

- **It seems possible to assess in advance the comparative difficulty of a specific post merger integration**

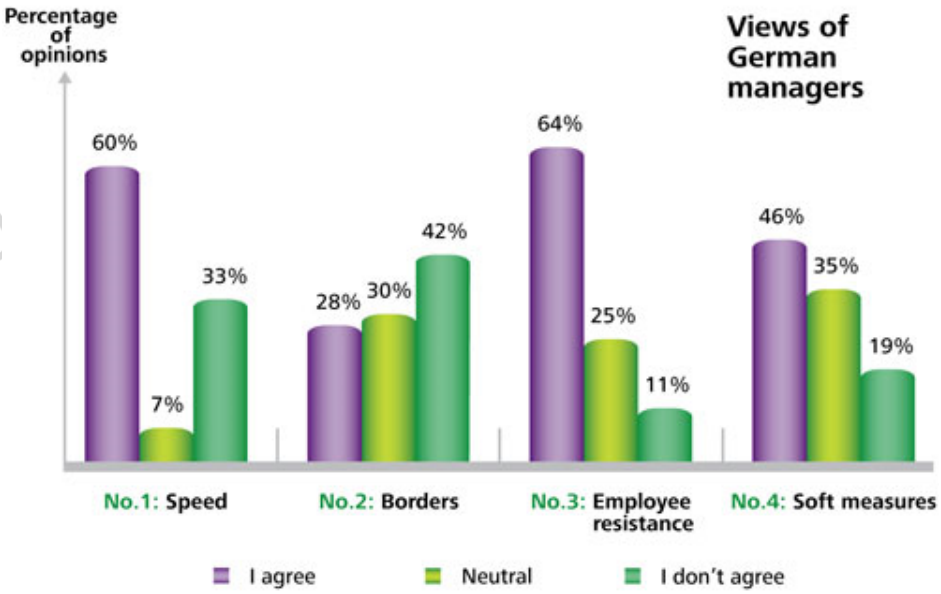


- Mikado as mastering the skill to pick up one stick after another …
  - … with moderate levels of risk in any of the four risk classes
- Dominos mergers are symbolized by high synergy and project risks …
  - … with people risks quite marginal for this merger type; there was likely no resistance from managers and employees
- Poker-variety mergers are marked with a high degree of heterogeneity in both organizational and process structure
  - … whilst marked with insufficient human resource capabilities: they were understaffed and suffered from inadequate expertise from the acquiring company

Post-Merger Integration Risk and Merger Success Rate (cont´d)

PMI myths or formulas for success?

- No.1: *"The faster, the better!"*
- No.2: *"National mergers are less risky than cross-border mergers!"*
- No.3: *"Employee resistance is the greatest barrier to integration!"*
- No.4: *"Soft factors are more important than hard factors!"*



Managing M&A Transaction Risk

Housekeeping

- Prior to embarking on a sale process: Get ‘house in order’
- Undertake informal or formal **vendor due diligence** prior to embarking upon a sale

Confidential information

- Non-Disclosure Agreement (NDA) or Confidentiality Agreement (CA)
- In reality, the NDA/CA is a fairly 'blunt instrument'
  - In reality, though, it is inherently **difficult to prove a breach of confidentiality** and, if proved, to then quantify the loss suffered

Data Room

- The data room is usually a **virtual data room** (VDR)
- All information 'fully and fairly' disclosed in the data room would **usually qualify the warranties given by the seller**
  - It is therefore imperative that a seller ensures that all relevant information is uploaded into the VDR.
- As **competitors of the seller** may well be given access to the VDR, further practices have developed to enable a seller to control its confidential information
  - One such practice is the redacting of information from sensitive commercial documents
  - In addition, a **'black box' within the VDR** is often established to contain a discrete number of extremely commercially sensitive documents which will only be **disclosed** to the ultimate buyer **immediately prior to execution of a sale** and purchase agreement (SPA)

Counterparty Risk

- At a minimum, a seller needs to obtain some comfort as to the valid incorporation and 'good standing' of the buyer
- Quite often a special purpose vehicle (**SPV**) is established by the buyer late in the transaction to acquire the shares from the seller
- Where an SPV is established by the buyer (or the buyer itself does not have sufficient financial standing) consideration should be given to a **deposit** being paid by the buyer upon signing the SPA **and/or** a **parent guarantee** being provided

Completion Risk

- Many deals are not signed and completed on the same day but are subject to a number of **conditions precedent** (CPs)
  - This immediately creates completion risk for a seller (and possibly the buyer) which must be managed
- A **seller should 'push back' on open ended CPs** such as board approval of the buyer, the buyer undertaking and being satisfied with its due diligence investigation, subject to finance conditions, etc
  - All of such CPs effectively give the buyer a call option to acquire the seller's business and should be resisted
- A **seller should also push back on CPs relating to material adverse change** and breach of warranty **between signing and completion** of the SPA
- In practice, a seller may be required to live with a certain number of conditions precedent
- **Change of control consents should be limited** to a small number of key material contracts
  - Inevitable regulatory approvals such as foreign investment and competition law clearance may be required

Calculation and Adjustment of Purchase Price

- **Balance sheet purchase price adjustment provisions** have become the norm and have increased in their complexity
  - This can add risk to both a seller and a buyer in the form of an unexpected adjustment to the purchase price
  - It is critical that these provisions are checked and signed-off by a seller's accountants and corporate advisers.

- **Private equity** has introduced a simplified mechanism referred to as a '**Locked Box**'
  - Under this mechanism, the accounts are ruled off at a particular date, and **after** that **date** all **profits and losses of the business are to the account of the buyer**
  - The seller and buyer **agree upon permitted and non-permitted 'leakages' of cash** from the business
  - The appeal to a seller is that the 'Locked Box' provides certainty as to the proceeds they will receive at completion

Earn Outs

- A buyer will often insist that **part of the purchase price** payable be calculated by reference to the **post completion performance** of the business
  - In doing so, a seller's sale proceeds are at risk for the relevant period if the business does not perform in accordance with expectations

- As the **buyer will have control** of the business for the relevant period, it is critical that the **seller's risk** be properly managed

  1. The **buyer** will be subject to a set of **obligations regarding** its **conduct of the business during** the **earn out** period
     - As a general proposition, a buyer should be required to the conduct the target business in substantially the same manner as it was conducted prior to completion

  2. The **SPA** would usually **contain** a series of **principles** which will be **applied to 'normalise' the earnings** in the accounts of the business which will be used to calculate the earn out amount

Warranties and Indemnities

Financial caps

- It is customary for a seller and buyer to agree upon a **maximum aggregate 'cap' on the seller's liability** for breach of warranties (and claims under specific indemnities such as tax, title, environmental, etc)
  - Historically, the cap was set at an amount equal to the **purchase price**
  - With the growth of private equity, buyers (particularly PE buyers) have been prepared to accept caps set at a **percentage of the purchase price**
  - Quite often **different** caps are agreed **for different types** of warranties/indemnities.

De minimis

- To avoid the risk of a seller being subject to multiple immaterial claims for breach of warranty, the parties will agree a 'de minimis' or **minimum claim threshold**
  - The parties will often also agree on a 'tipping' or 'non-tipping' basket of claims (i.e., an aggregate threshold that must be reached prior to a buyer being able to recover its losses from the seller)

Time limits

- A seller will seek a time limit within which a warranty or indemnity claim can be made by the buyer
  - Once the agreed time limit expires, no claims may be brought
  - As with financial caps, **differing time limits** will often be agreed between the parties in respect of differing subject matter of claims
  - For instance, tax warranties may have a longer applicable time limit than a claim under a 'general' warranty and no time limit may apply to a breach of a title warranty

Warranties and Indemnities

Disclosure

- A **key risk mitigation strategy for a seller is the disclosure** of all relevant information to the buyer
  - Matters which are fully and fairly disclosed to the buyer prior to execution of the SPA will not usually be able to form part of a claim for breach of warranty
  - A seller should ensure that known issues are disclosed to a buyer either through the VDR or by way of a disclosure letter to be issued immediately prior to execution of the SPA

Actual knowledge

- A seller should ensure that any matter which is within the **knowledge of the buyer prior to execution** of the SPA is **not** able to form **part of** a **warranty claim**
  - Whilst often a seller will push for 'constructive knowledge' of a buyer to be included, at a minimum, actual knowledge of a buyer's deal team should constitute this limitation

Publicly available information

- A buyer who has conducted due diligence should be required to bear the risk of information discovered during its due diligence investigations
  - In this regard, any information which is a matter of public record including through searching publicly available registers should be excluded from a claim for breach of warranty

Warranties and Indemnities

Other limitations

- A customary series of further **limitations** will often be agreed between a buyer and a seller, including exclusion of liability for consequential loss and liabilities arising where a warranty becomes untrue due to a change which is **outside of the control of the parties** (for instance, a change in law)

Warranty and indemnity insurance

- Another means by which a seller may mitigate its warranty and indemnity risk is through a policy of warranty and indemnity insurance
  - The use of W&I insurance has increased considerably over the last 5-10 years in response to the growth in private equity
  - This is a complicated area of law which will no doubt be tested in the courts over the coming years
  - As a general rule, a seller should push for a 'buy side' policy to be taken out by a buyer so that the buyer's recourse is, subject to certain exceptions, against the insurer and not the seller

Managing M&A Risk with Collars, Earn-outs, and CVRs

Pre-closing Risk Management: Collar Offers

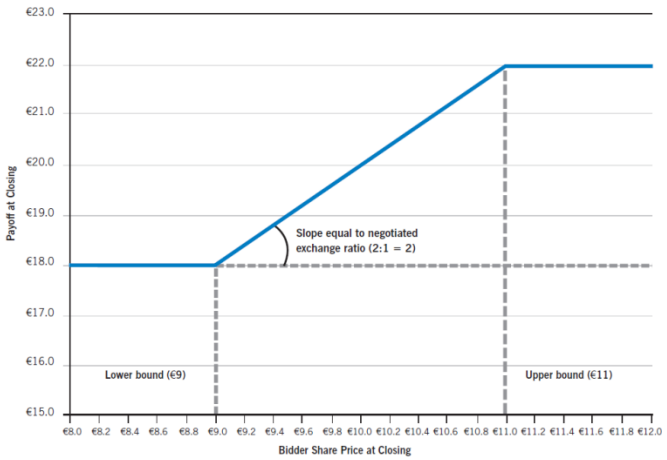
- Stock price volatility has always been a problem in M&A deals …
  - … particularly those involving two listed companies that are structured as stock-for-stock swaps
- In many such cases, the pre-closing price risk has been hedged using **plain vanilla equity derivatives**, such as call and put options
  - In all-cash acquisitions of listed companies, the bidding company can protect itself by acquiring call options on the shares
  - The target company's shareholders can acquire put options on their shares
  - If the transaction is stock-financed, it might hedge by acquiring put options on the bidder's stock
- But **what if** one (or both) of the companies lose interest in the deal if the stock prices of the companies involved **change materially**?
  - M&A practice has developed a particular kind of contingent offer, called a "collar offer"
  - Option to walk away from the deal if the **bidder stock price falls below a certain level** …
  - … or the **ratio of the bidder's to the target's stock price moves outside a pre-specified range**
  - If the ratio falls below the lower or rises above the upper bound of the collar, an option to abandon comes into effect (also known as a "sudden birth" option) that can be exercised by either counterparty

Payoff Structure for a Typical Fixed Collar Offer

- In a pre-negotiation of the exchange ratio (for example, two shares of the bidding company for each share of the target company, or 2:1) that will be used in the transaction, and an agreement on a trading collar for the bidder share price
- For example, if the bidder's share price during the negotiations is around €10, the parties might agree to a collar that ranges between €9 and €11, which effectively establishes an acceptable range of values for the target from €18 to €22

Payoff Structure for a Typical Fixed Collar Offer as a Function of Bidder Company Share Price at Closing

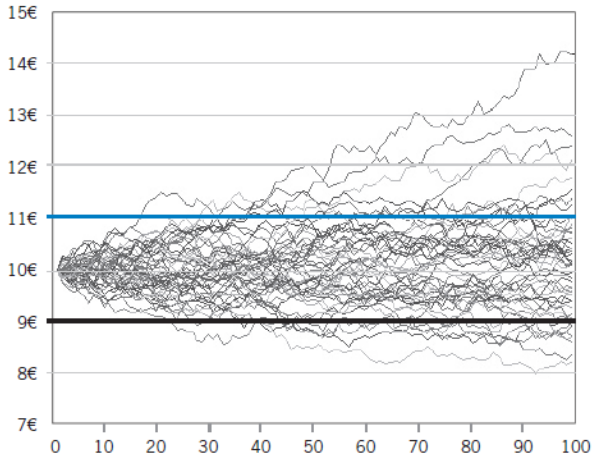
- When the bidder share price falls between the lower and upper bound (e.g. €9 and €11), the transaction is settled at the pre-negotiated exchange ratio (2:1 in the numerical example)
- This implies that in such a case the cash value of total consideration received by the target shareholders is a linear function of the bidder company share price
  - **Outside of the two bounds, the exchange ratio is free to float**, guaranteeing a fixed cash amount to the target shareholders; even more importantly, the abandon option becomes exercisable



Building Expectations Into a Fixed-price Collar

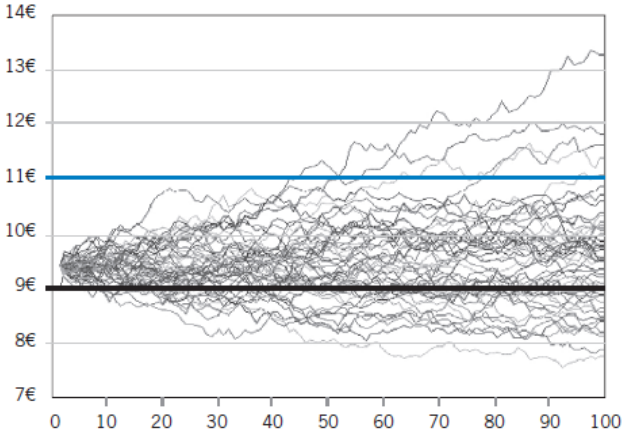
Possible future paths followed by a stock price that equals **€10 at present**, based on Monte Carlo simulations

- A collar (€9-11) is also shown by the two parallel horizontal lines



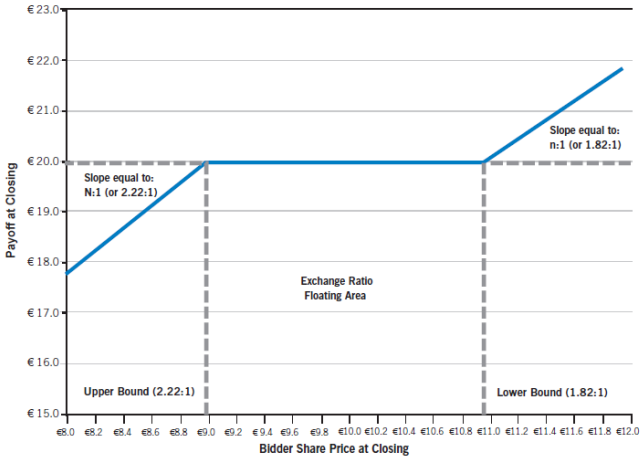
Possible future paths of the same stock when **negative abnormal stock returns** are accounted for, as a reduction in the share price at time zero (**€9.5** instead of €10.0)

- A collar (€9-11) is also shown by the two parallel horizontal lines



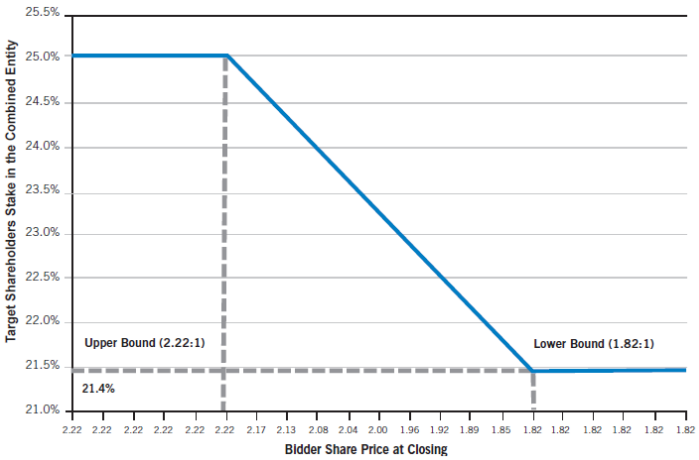
Floating Collar Offer Payoff Structure

- When the exchange ratio calculated at current market value falls between the lower and the upper bound at closing, the total consideration paid is fixed (horizontal segment)
- Outside the two bounds, the total consideration is a linear function of the bidder company share price, with a slope equal to the exchange ratio implied in the violated bound



Floating Collar Offer Shareholding Structure

- The stake obtained by the target company's shareholders in the merged entity as a function of the exchange ratio used in the transaction
  - The constant cash amount has been assumed to be €20 for each target company's share, while the bidder company share price ranges from €9 to €11
  - The number of bidder company shares outstanding is assumed to be 100 million, the target company's shares outstanding are assumed to be 15 million
  - Lower and upper bounds are assumed to be 1.82:1 and 2.22:1, respectively
  - Given the particular payment structure, in this transaction the target company shareholders' stake in the combined entity ranges from 21.4% to 25%, corresponding to a 1.82:1 and to a 2.22:1 exchange ratio, respectively
  - Within the two bounds, cash consideration paid is fixed at €20 per share



Summary of Payoffs for the Two Collar Offers Described

	Fixed Collar Offer			Floating Collar Offer			
	Bidder Stock Price at Closing	Payoff at Closing	Transaction Exchange ratio	Bidder Stock Price at Closing	Payoff at Closing	Transaction Exchange Ratio	
	€ 8.0	€ 18.0	2.25	€ 8.0	€ 17.8	2.22	
	€ 8.2	€ 18.0	2.20	€ 8.2	€ 18.2	2.22	
	€ 8.4	€ 18.0	2.14	€ 8.4	€ 18.6	2.22	
	€ 8.6	€ 18.0	2.09	€ 8.6	€ 19.1	2.22	
	€ 8.8	€ 18.0	2.05	€ 8.8	€ 19.5	2.22	
Lower Bound	€ 9.0	€ 18.0	2.00	€ 9.0	€ 20.0	2.22	Upper Bound
	€ 9.2	€ 18.4	2.00	€ 9.2	€ 20.0	2.17	
	€ 9.4	€ 18.8	2.00	€ 9.4	€ 20.0	2.13	
	€ 9.6	€ 19.2	2.00	€ 9.6	€ 20.0	2.08	
	€ 9.8	€ 19.6	2.00	€ 9.8	€ 20.0	2.04	
	€ 10.0	€ 20.0	2.00	€ 10.0	€ 20.0	2.00	
	€ 10.2	€ 20.4	2.00	€ 10.2	€ 20.0	1.96	
	€ 10.4	€ 20.8	2.00	€ 10.4	€ 20.0	1.92	
	€ 10.6	€ 21.2	2.00	€ 10.6	€ 20.0	1.89	
	€ 10.8	€ 21.6	2.00	€ 10.8	€ 20.0	1.85	
Upper Bound	**11.0**	**22.0**	**2.00**	**11.0**	**20.0**	**1.82**	Lower Bound
	€ 11.2	€ 22.0	1.96	€ 11.2	€ 20.4	1.82	
	€ 11.4	€ 22.0	1.93	€ 11.4	€ 20.7	1.82	
	€ 11.6	€ 22.0	1.90	€ 11.6	€ 21.1	1.82	
	€ 11.8	€ 22.0	1.86	€ 11.8	€ 21.5	1.82	
	€ 12.0	€ 22.0	1.83	€ 12.0	€ 21.8	1.82	

Fixed vs. Floating Collar Offers: Pros and Cons

	Fixed Collar Offers		Floating Collar Offers	
	Pros	**Cons**	**Pros**	**Cons**
Bidder Company	• Dilution risk minimized (pre-negotiated exch. ratio) • Simpler to negotiate vs. floating collar offers • Abandon option outside of negotiated bounds	• Price risk management sub-optimal in presence of small relative move-ments of bidder vs. target share prices	• Perfect risk management of the cash value of the consideration paid • Abandon option outside of negotiated bounds	• Sub-optimal dilution risk management
Target Company	• Achievement of a pre-negotiated interest in the bidder company • Abandon option outside of negotiated bounds	• Price risk management sub-optimal in presence of small relative movements of bidder vs. target share prices	• Guaranteed cash value of the *medium of exchange* • Abandon option outside of negotiated bounds	• Uncertainty regarding the pro-forma ownership structure

Dealing with Post-merger Uncertainty

- Although collar offers can have significant benefits in a competitive bidding environment and reduce overall transaction costs, they offer no protection against the possibility that the target will fail to live up to expectations after the deal closes

- Should the two integrated companies fail to realize most of the expected synergies, the bidder company will likely have overpaid for the target

- M&A practice has developed two main instruments to manage performance risk in the integration (or post-closing) phase:

  – Earn-outs and
  – Contingent value rights

The Use of Earn-outs

- Earn-outs allow the parties to limit the effects of such uncertainty by **dividing the payment into two tranches**
- The **first tranche is certain to be paid out**, and is usually settled at the closing of the transaction
- The **second tranche will be paid at a future date only if certain conditions**, negotiated in the present, are met and is typically tied to the target company's future performance
- The likelihood of using an earn-out contract depends on how much uncertainty there is about the target company's true value
  - Although synergies can be an important consideration, the valuation of the target will often depend heavily on the target's future expected performance as a stand-alone entity
- By structuring the deal with an upfront payment plus an earn-out, acquirers can reduce the risk of mispricing the target company to the point where their only risk is that the cash consideration paid at the closing exceeds the target company's fair value plus realized synergies

Contingent Value Rights

- **A CVR is a type of right given to shareholders of an acquired company (or a company facing major restructuring) that ensures they receive additional benefit if a specified event occurs**
- **A contingent value right is similar to an option because it often has an expiration date that relates to the time the contingent event must occur**

- Contingent value rights (CVRs) **range from plain vanilla to exotic stock options** that are issued in stock-financed M&A transactions
- CVRs are used in many transactions, often under different names such as warrants or stock options, and are frequently listed on regulated markets
- From a technical standpoint, CVRs are flexible instruments that are often structured as “binary” (or “digital”) options that result in all-or-nothing payments
- In this case, the instrument pay-off does not depend in a linear way on the underlying asset price, but rather involves a bullet payment made either in cash or in stock
- In a typical stock payment, the stocks to be assigned under the CVR agreement are issued at the transaction closing and then deposited into an escrow account

Contingent Value Rights - … and their Dark Side

… place all the risk associated with the acquisition on the backs of investors in their target corporation?

- The conditional nature of CVRs makes them **valuable in breaking logjams in price negotiations**
  - Shareholders in target companies may not get as much cash or stock in the transaction as they would like, but they do get the equivalent of a lottery ticket

- After the financial crisis vastly amplified market volatility, CVRs began to play an **increasing role in** many mergers and acquisitions, especially in the **risk-laden biotech and pharmaceutical sectors**
  - Financial Accounting Statement 141(R) requires that CVRs be recorded at "fair value" as of the acquisition date on the issuer's books as a liability
  - Because the issuer determines the fair value of the CVR by designating a discount rate that purportedly estimates the likelihood that the milestones will or will not occur, the fair value measurement itself is highly controversial
  - An additional risk CVR recipients are required to bear is CVRs' lack of liquidity. Although some CVRs are registered tradable securities, the majority are non-transferable because the issuing company does not want to incur the additional cost, disclosure obligations, and legal responsibilities associated with registering them with the SEC.
  - The most troubling aspect of CVRs from an investor standpoint, however, is the way the instruments redistribute risk in deals.: After all, CVRs are only payable upon the occurrence of some milestone event by a future date. If the milestone is never reached, or is reached, but too late, the acquirer pays nothing

Risk-Based Due Diligence

The Issue

- The economic crisis, vigorous governmental enforcement activity and the increased focus on enterprise risk are causing global corporations and their audit committees to take a closer look at how they manage and conduct their due diligence around …:
  - **Vendor** organisations,
  - **Distributor** organisations,
  - Joint ventures and
  - **Customer** organizations —
  - … defined broadly as third parties

The Issue (cont´d)

Guidance provides for leading practices for ensuring effective internal controls, ethics and compliance programs or measures for the purpose of preventing and detecting foreign bribery

- Strong, explicit and visible **support and commitment from senior management**
- **Ethics** and compliance programs or measures designed to prevent and detect **foreign bribery** applicable, where appropriate …
  - … and subject to contractual arrangements, to third parties such as agents and other intermediaries, consultants, representatives, distributors, contractors
- Effective measures for:
  - Providing guidance and advice to directors, officers, employees and, where appropriate, business partners on complying with the company's ethics and compliance program
  - Internal and, where possible, confidential reporting by, and protection of, directors, officers, employees and, where appropriate, business partners not willing to violate professional standards or ethics
  - Undertaking appropriate action in response to such reports
- Periodic reviews of the ethics and compliance programs

Legal Drivers

Due Diligence Driver	Reference	Summary
FCPA	15 U.S.C. §§ 78dd-1, et seq.	Driver because of the 'directly or indirectly' clause and the liability for third-party risk. Supported by the case law of willful blindness.
Attorney General Guidance		Encourages US companies to exercise due diligence to avoid being held liable for corrupt third-party payments.
US Federal Sentencing Guidelines		Creates a back-end requirement for performing due diligence by indicating that companies that have a strong compliance program, which includes due diligence, will receive 'credit' during sentencing, thus creating lower fines and penalties.
USA Patriot Act	Section 312 Section 5318(i)	Requires financial institutions to establish due diligence policies to detect and report money laundering and sets forth the minimum due diligence standards for financial institutions to perform on non-US persons.
Sarbanes-Oxley	Section 404(a) and Section 404(b)	Requires US public companies to maintain adequate internal controls over financial reporting and, thus, is an indirect due diligence driver.
UK Bribery Act		Criminalizes the 'failure to prevent bribery' and provides a defense of having 'adequate procedures' to prevent bribery. The fourth principle of the MOJ guidance focuses on performing risk-based due diligence on intermediaries.
OECD Good Practices Guidance	Paragraph 6	The guidance provides a list of good practices to consider as part of an effective compliance program, including documenting the risk-based due diligence procedures performed, findings identified, approvals in hiring decisions, and the performance of regular oversight.
World Bank Integrity Compliance Group	Section 5.1	Requires compliance programs to include the performance of due diligence on intermediaries for entities seeking to end a debarment or conditional debarment.
TI Business Principles	Section 5.2.2.1 Section 5.2.3.2 Section 5.2.4.2	Considered a best practices guide for designing and benchmarking compliance programs and includes the performance of due diligence on intermediaries in its recommendations.
PACI Principles	Section 5.2.2.1 Section 5.2.3.1 Section 5.2.3.2 Section 5.2.3.2.1 Section 5.2.4.2	Considered a best practices guide for designing compliance programs and includes the performance of due diligence on intermediaries in its recommendations. This guidance is not a requirement, but merely a guide for organizations of all sizes.

Survey Themes

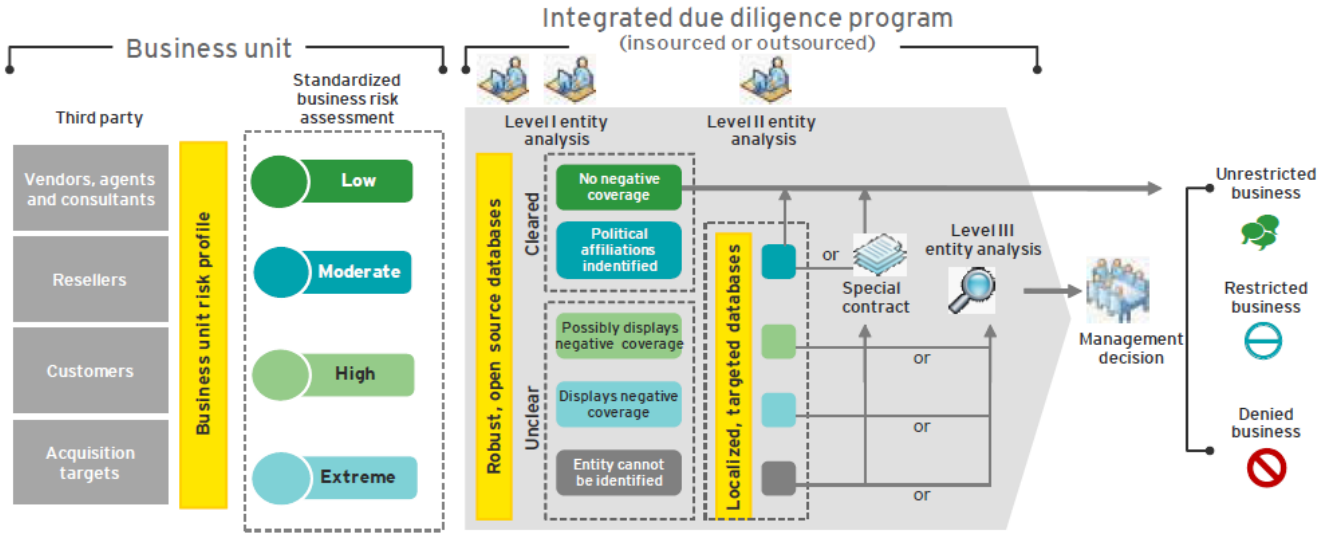
Examples of survey themes

- Nature of the services to be provided by the intermediary
- Areas of geographical operations
- Shareholder information
- Management information
- Use of intermediaries
- Relationships with government entities or officials
- Sales to or interaction with government entities or officials
- Historical compliance issues
- Potential conflicts of interest with the organization
- The intermediary's internal control environment

Examples of risk indicators

- Information contradictory to survey responses and/or existing data
- Previous regulatory compliance issues (e.g., FCPA, anti-money laundering, trade and export, piracy and grey market, etc.)
- Litigation matters
- Relationships with government officials
- Relationships that present a conflict of interest with the organization or other intermediaries

Third-Party Due Diligence



Due Diligence Activities In A Merger And Acquisition Transaction

Checklist

Financial Matters

- What do the company's annual, quarterly, and (if available) monthly financial statements for the last three years reveal about its financial performance and condition?
- Are the company's financial statements audited, and if so for how long?
- Do the financial statements and related notes set forth all liabilities of the company, both current and contingent?
- Are the margins for the business growing or deteriorating?
- Are the company's projections for the future and underlying assumptions reasonable and believable?
- How do the company's projections for the current year compare to the board-approved budget for the same period?
- What normalized working capital will be necessary to continue running the business?
- How is "working capital" determined for purposes of the acquisition agreement? (Definitional differences can result in a large variance of the dollar number.)
- What capital expenditures and other investments will need to be made to continue growing the business, and what are the company's current capital commitments?
- What is the condition of assets and liens thereon?
- What indebtedness is outstanding or guaranteed by the company, what are its terms, and when does it have to be repaid?

Financial Matters (cont´d)

- Are there any unusual revenue recognition issues for the company or the industry in which it operates?
- What is the aging of accounts receivable, and are there any other accounts receivable issues?
- Should a “quality of earnings” report be commissioned?
- Are the capital and operating budgets appropriate, or have necessary capital expenditures been deferred?
- Has EBITDA and any adjustments to EBITDA been appropriately calculated? (This is particularly important if the buyer is obtaining debt financing.)
- Does the company have sufficient financial resources to both continue operating in the ordinary course and cover its transaction expenses between the time of diligence and the anticipated closing date of the acquisition?

Technology/Intellectual Property

- What domestic and foreign patents (and patents pending) does the company have?
- Has the company taken appropriate steps to protect its intellectual property (including confidentiality and invention assignment agreements with current and former employees and consultants)? Are there any material exceptions from such assignments (rights preserved by employees and consultants)?
- What registered and common law trademarks and service marks does the company have?
- What copyrighted products and materials are used, controlled, or owned by the company?
- Does the company's business depend on the maintenance of any trade secrets, and if so what steps has the company taken to preserve their secrecy?
- Is the company infringing on (or has the company infringed on) the intellectual property rights of any third party, and are any third parties infringing on (or have third parties infringed on) the company's intellectual property rights?
- Is the company involved in any intellectual property litigation or other disputes (patent litigation can be very expensive), or received any offers to license or demand letters from third parties?
- What technology in-licenses does the company have and how critical are they to the company's business?
- Has the company granted any exclusive technology licenses to third parties?

Technology/Intellectual Property (cont´d)

- Has the company historically incorporated open source software into its products, and if so does the company have any open source software issues?
- What software is critical to the company's operations, and does the company have appropriate licenses for that software (and does the company's usage of that software comply with use limitations or other restrictions)?
- Is the company a party to any source or object code escrow arrangements?
- What indemnities has the company provided to (or obtained from) third parties with respect to possible intellectual property disputes or problems?
- Are there any other liens or encumbrances on the company's intellectual property?

Customers/Sales

- Who are the top 20 customers and what revenues are generated from each of them?
- What customer concentration issues/risks are there?
- Will there be any issues in keeping customers after the acquisition (including issues relating to the identity of the buyer)?
- How satisfied are the customers with their relationship with the company? (Customer calls will often be appropriate.)
- Are there any warranty issues with current or former customers?
- What is the customer backlog?
- What are the sales terms/policies, and have there been any unusual levels of returns/exchanges/refunds?
- How are sales people compensated/motivated, and what effect will the transaction have on the financial incentives offered to employees?
- What seasonality in revenue and working capital requirements does the company typically experience?

Strategic Fit with Buyer

- Will there be a strategic fit between the company and the buyer, and is the perception of that fit based on a historical business relationship or merely on unproven future expectations?
- Does the company provide products, services, or technology the buyer doesn't have?
- Will the company provide key people (is this an acqui-hire?) and if so what is the likelihood of their retention following the closing?
- What integration will be necessary, how long will the process take, and how much will it cost?
- What cost savings and other synergies will be obtainable after the acquisition?
- What marginal costs (e.g., costs of obtaining third party consents) might be generated by the acquisition?
- What revenue enhancements will occur after the acquisition?

Material Contracts

- Guaranties, loans, and credit agreements
- Customer and supplier contracts
- Agreements of partnership or joint venture; limited liability company or operating agreements
- Contracts involving payments over a material dollar threshold
- Settlement agreements
- Past acquisition agreements
- Equipment leases
- Indemnification agreements
- Employment agreements
- Exclusivity agreements
- Agreements imposing any restriction on the right or ability of the company (or a buyer) to compete in any line of business or in any geographic region with any other person
- Real estate leases/purchase agreements
- License agreements
- Powers of attorney
- Franchise agreements
- Equity finance agreements
- Distribution, dealer, sales agency, or advertising agreements
- Non-competition agreements
- Union contracts and collective bargaining agreements
- Contracts the termination of which would result in a material adverse effect on the company
- Any approvals required of other parties to material contracts due to a change in control or assignment

Employee/Management Issues

- Management organization chart and biographical information
- Summary of any labor disputes
- Information concerning any previous, pending, or threatened labor stoppage
- Employment and consulting agreements, loan agreements, and documents relating to other transactions with officers, directors, key employees, and related parties
- Schedule of compensation paid to officers, directors, and key employees for the three most recent fiscal years showing separately salary, bonuses, and non-cash compensation (e.g., use of cars, property, etc.)
- Summary of employee benefits and copies of any pension, profit sharing, deferred compensation, and retirement plans
- Evidence of compliance with IRS Section 409A in connection with stock option issuances
- Summary of management incentive or bonus plans not included in above as well as other forms of non-cash compensation
- Likelihood of need for compliance with IRS Section 280G (golden parachute) rules in connection with any potential acquisition
- Employment manuals and policies
- Involvement of key employees and officers in criminal proceedings or significant civil litigation

Employee/Management Issues (cont´d)

- Plans relating to severance or termination pay, vacation, sick leave, loans, or other extensions of credit, loan guarantees, relocation assistance, educational assistance, tuition payments, employee benefits, workers' compensation, executive compensation, or fringe benefits
- Appropriateness of the company's treatment of personnel as independent contractors vs. employees
- Actuarial reports for past three years
- What agreements/incentive arrangements are in place with key employees to be retained by the buyer? Will these be sufficient to retain key employees?
- What layoffs and resultant severance costs will be likely in connection with the acquisition?

Litigation

- Filed or pending litigation, together with all complaints and other pleadings
- Litigation settled and the terms of settlement
- Claims threatened against the company
- Consent decrees, injunctions, judgments, or orders against the company
- Attorneys' letters to auditors
- Insurance covering any claims, together with notices to insurance carriers
- Matters in arbitration
- Pending or threatened governmental proceedings against the company (SEC, FTC, FDA, etc.)
- Potentially speaking directly to the company's outside counsel

Tax Matters

- Federal, state, local, and foreign incomes sales and other tax returns filed in the last five years
- Government audits
- Copies of any correspondence or notice from any foreign, federal, state, or local taxing authority regarding any filed tax return (or any failure to file)
- Tax sharing and transfer pricing agreements
- Net operating losses or credit carryforwards (including how a change in control might affect the availability thereof)
- IRS Form 5500 for 401(k) plans
- Agreements waiving or extending the tax statute of limitations
- Allocation of acquisition purchase price issues
- Correspondence with taxing authorities regarding key tax items
- Settlement documents with the IRS or other government taxing authorities

Antitrust and Regulatory Issues

- If the buyer is a competitor of the target company, understanding and working around any limitations imposed by the company on the scope or timing of diligence disclosures
- Analyzing scope of any antitrust issues
- If the company is in a regulated industry that requires approval of an acquisition from a regulator, understanding the issues involved in pursuing and obtaining approval
- Confirming if the company has been involved in prior antitrust or regulatory inquiries or investigations
- Addressing issues that may be involved in preparing a Hart-Scott-Rodino filing (if thresholds are met) and effectively responding to any "second request" from the Department of Justice or Federal Trade Commission
- Considering Exon-Florio issues if the transaction involves national security or foreign investment issues
- Other Department of Commerce filings if the buyer is a foreign entity
- Understanding how consolidation trends in the company's industry might impact the likelihood and speed of antitrust or regulatory approval

Insurance

- If applicable, the extent of self-insurance arrangements
- General liability insurance
- D&O insurance
- Intellectual property insurance
- Car insurance
- Health insurance
- E&O insurance
- Key man insurance
- Employee liability insurance
- Worker's compensation insurance
- Umbrella policies

Contact

Christian Schopper
Private: christian.schopper@aon.at
Business: christian.schopper@corpfince.com

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