

# Holland & Knight

**National Defense Industrial Association (NDIA)  
7th Annual National Small Business Conference**

## **Current M&A Environment and Trends in Defense M&A Deal Terms**

**Adam J. August | William J. Mutryn**

**Corporate and Merger & Acquisitions Practice Group**

**(703) 720-8600 | [www.hklaw.com](http://www.hklaw.com)**

May 25-26, 2010

Huntsville, AL

# About Holland & Knight

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- Global law firm with nearly 1,000 attorneys in 17 U.S. offices and Abu Dhabi, Beijing and Mexico City
- Represented parties in approximately 100 M&A transactions involving Government Contractors over the last 5 years
- Corporate, M&A and Securities Group: 20 attorneys in the Mid-Atlantic Region and 120 nationally focusing on serving the middle market companies in M&A transactions, securities, finance and corporate governance
- Experienced attorneys in tax, employee benefits, government contracts, intellectual property, environmental, real estate, employment and antitrust to perform M&A transactions
- Securities: focuses on advising middle-market companies regarding SEC reporting and compliance, public offerings of securities, high yield debt offerings, and private placements

# Trends In Defense M&A Terms

- A Broad Array of Buyers in the Marketplace:
  - Defense primes and Tier 2
  - Private or small cap public strategic
  - Private equity sponsors and portfolio companies
  - Former sellers re-entering the marketplace
  - Foreign
  - Primarily commercial/diversified

# Trends In Defense M&A Terms

- Buyers Are Seeking Firms That Will Provide:
  - Additional customer relationships and contract vehicles
  - New capabilities and experience base
  - New product or service offerings
  - Revenue and EBITDA Growth
  - Technologies that provide competitive advantages
  - Platform with management talent
  - Geographic diversification

# Trends In Defense M&A Terms

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## Factors That Affect M&A Transaction Terms:

- Competitive demand for Target, e.g., auction process vs. single purchaser
- Risk tolerance and historical practices of particular Purchaser
- Composition of Seller group
- Importance of management retention
- Nature and magnitude of perceived business and legal risks
- Overall Target preparation and compliance posture
- Willingness of parties to negotiate and find creative solutions
- Valuation of Target by Purchaser

# Trends In Defense M&A Terms

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What Factors Are Causing firms to Consider a Sale?

- Changes in forecasts for Defense budget
- Impending increases in capital gains tax
- Competitive challenges: pricing, business development
- Program uncertainty
- Adequate valuation levels
- Robust demand from potential purchasers

# Trends In Defense M&A Terms

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What Factors Are Causing Firms to Consider Purchasing?

- Government is a safe haven with some predictability in spending
- Strategic Buyers have available cash earnings shall return
- Private Equity Sponsors have unused commitments and available financing
- Valuations are down from highs
- Strategic Buyers have pressure to maintain growth
- Private Equity Sponsors have witnessed recent history of favorable returns
- Strategic Buyers' need for technology and intellectual property

# Trends In Defense M&A Terms

## Macro Trends:

- Robust Activity – many firms are either Purchasers or Sellers
- Purchasers are VERY PARTICULAR – seeking the right deal at the right price
- Increased challenges for deals to be completed
- 2-Tiers of companies for valuation purposes
- Purchasers seeking stronger risk protection terms
- 10 principal trends in transaction terms



# Trends in Defense M&A Terms

## **Trend 1: More Extensive Negotiation of a More-Detailed Letter of Intent or Term Sheet**

- Frequently follows some due diligence by Purchaser
- Items addressed:
  - Structure, purchase price and consideration and assumptions behind purchase price
  - Escrow or holdback
  - Working capital requirements
  - Principal closing conditions

# Trends in Defense M&A Terms

*Trend 1, Letter of Intent/Term Sheet, continued...*

- Indemnity caps, baskets and survival periods
- Non-competes and key employee retention
- Due diligence process
- Exclusive negotiation period
- Exclusivity Period may be staged based on completion of diligence, financing commitment and distribution of draft documents
- Parties' mutual interests to avoid future surprises on major terms

# Trends in Defense M&A Terms

## **Trend 2: Increased Sophistication Purchaser Due Diligence and Concentration on Critical Areas:**

- Revenue waterfall
- Backlog, including program assessment
- Contract terms, including set-aside restrictions, OCI analysis
- Margin sustainability and adequacy of business infrastructure
- Customer relationships and insourcing risk
- Key employee skills and employment continuity

# Trends in Defense M&A Terms

*Trend 2, Purchaser Due Diligence, continued...*

- Taxes: income, foreign, sales and use
- Focus on compliance:
  - Government contracts
  - Employment
  - Employee benefits
  - Export controls
  - FCPA
- Capitalization
- Intellectual Property
- IT system adequacy and security

# Trends in Defense M&A Terms

## **Trend 3: Increased Escrow and Other Protections for Purchaser from Post-Closing Losses**

- Escrows/Holdbacks –previously 5% to 10% but now frequently 10% to 20% of purchase price; generally held for 18 months or more to secure indemnity claims and working capital deficiency
  - Some Purchasers seeking holdbacks or seller financing instead of escrows to reduce financing required
  - Specific subaccounts for identified risks: working capital, general indemnity claims, other identified risks, such as ongoing audits or litigation

# Trends in Defense M&A Terms

*Trend 3, Purchaser Protections, continued...*

- Duration of escrow or holdback varies based on perceived risks
- Ability for Purchaser to extend escrow or holdback if good faith basis for claim
- Escrow/holdback amount typically higher if it is the principal or exclusive source of any recovery for indemnity claims

# Trends in Defense M&A Terms

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## Trend 4: Increased Emphasis on Employee Retention

- Many Purchasers require as a closing condition that key employees of Target execute retention agreements and a percentage of other direct employees sign standard employee agreements
- Retention or bonus agreements generally contain stay-bonus provisions plus non-solicitation covenants with respect to customers and employees
- Highest level key employees may be required to sign employment agreements as a closing condition, particularly if Purchaser is private equity firm or smaller cap strategic

# Trends in Defense M&A Terms

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*Trend 4, Employee Retention, continued...*

- Bonus payments sometimes are based on percent of entire management group that remains employed after period of time as well as other performance metrics
- Private equity Purchasers may require or encourage purchase of equity by key managers
- Strategic Purchasers often grant stock options or restricted stock to key employees



# Trends in Defense M&A Terms

## Trend 5: Continued Use of Earn-Outs

- Earn-outs – used by selected Purchasers if extraordinary growth projected, set-aside contracts or to bridge valuation gap
  - More widespread use by private equity and small and mid-tier strategic buyers willing to pay upside if financial projections are achieved or key contracts are maintained or migrated
  - Earn-out covenants in general becoming less restrictive to Purchaser; however covenants more extensive if EBITDA-based earn-out
  - Can be event-based or performance-based; usually no longer than 2 years from closing
  - Performance-based earn-outs based on revenues, gross profits, contribution margin or EBITDA
  - Earn-outs used less frequently by strategic buyers that prefer near-term integration of Target

# Trends in Defense M&A Terms

## **Trend 6: Purchaser's Concerns with Set-Aside Contracts Continues**

- Set-aside contracts and task orders generally afforded significantly-reduced value compared to full and open contracts
- Some Purchasers will not acquire Target with a material percentage of set-aside revenues
- Earn-outs payable on continuation of contracts, exercise of options and/or migration to full and open
- Concern over full and open contracts where customer takes small business credit
- More extensive customer due diligence conducted to examine
- Certain small businesses, owners without other affiliates or Native American firms may have ability to afford higher value for certain set-aside contracts

# Trends in Defense M&A Terms

## **Trend 7: Use of Creative Tax Structures to Achieve Step Up in Basis and Deferral of Rollover Equity**

- Many Purchasers attribute value to availability of step-up in basis of Target's assets from IRS Section 338(h)(10) or 754 election
- In transaction with rollover equity, creative tax structures have evolved to enable tax deferred treatment of rollover equity, in some cases even where there is a Section 338(h)(10) or 754 election
- Careful tax examination by Sellers of effects of Section 338(h)(10) election and installment sales treatment required
- Plus-up by Purchaser for portion of adverse tax effects occurs in many transactions

# Trends in Defense M&A Terms

## **Trend 8: Continued Importance of Target's Net Working Capital or Tangible Net Assets At Closing**

- Usually determined based on cash-free, debt-free net working capital of business over an agreed period before closing
- Most Purchasers seek to exclude or limit deferred tax assets
- Some Purchasers require an adjustment if Accounts Receivable not collected within an agreed time
- Reserves to be in accordance with GAAP
- Separate escrow or holdback to serve as payment source if a deficiency

# Trends in Defense M&A Terms

*Trend 8, Net Working Capital/Net Assets, continued...*

- Tax benefits from option termination payments and transaction bonus payments usually allocated to Sellers
- Built-in-gains tax or cash-to-accrual tax adjustment arising as a result of transaction usually included as liability
- Usual forms of adjustments:
  - (i) Both upward and downward;
  - (ii) Downward only; or
  - (iii) No adjustment if within range

# Trends in Defense M&A Terms

## Trend 9: Trend Toward Increased Protection to Purchasers for Indemnity Claims

- Survival Periods
  - General Reps and Warranties – 1 to 3 years
  - Fundamental reps, including capitalization, authority, title, brokers, absence of debt – indefinite or statute of limitations
  - Tax, ERISA, environmental – 30 to 60 days past statute of limitations
  - Government Contracts – as negotiated: same as general, 3 to 5 years, or statute of limitations

# Trends in Defense M&A Terms

*Trend 9, Purchaser Protections, continued...*

- Pre-closing covenants – indefinite or same as general
- Post-closing covenants and special indemnities – indefinite or statute of limitation
- ESOP-owned Target or widely-held Target in competitive auction – reps and warranties survive until escrow/holdback released, except for Fundamental
- Public Target – representations and warranties do not survive closing
- Indemnification
  - Sellers – typically joint and several, sometimes several (if limited number of Sellers); Widely-held or ESOP-owned – indemnification usually limited to escrow or holdback
  - Cap – typically 10% to 30% of purchase price for general representations based on circumstances

# Trends in Defense M&A Terms

## *Trend 9, Purchaser Protections, continued...*

- Potential exclusions from cap and/or basket: capitalization, authority, title, breach of covenants, fraud, willful misconduct, tax, ERISA, environmental, ongoing litigation/investigation/claims, special indemnities; Government Contracts may be treated in different ways based on circumstances
- “Materiality” scrape – elimination of “materiality” qualifiers for determining breach or loss becoming more frequent
- Basket – negotiated amount (generally 0.25% to 1.00% of purchase price) – deductible or first dollar (tipping basket)
- Minimum claim size becoming less frequent
- Anti-sandbagging provision is very rare in Government M&A deals



# Trends in Defense M&A Terms

## **Trend 10: Private Equity Transaction Structures Continues to Use Leverage and Investment by Sellers and Key Employees**

- Increased availability of senior and mezzanine debt in 2010 vs. 2009
- Consideration frequently consists of:
  - Cash
  - Subordinated notes
  - Rollover equity
  - Equity investment by key executives
  - Earn-outs

# Trends in Defense M&A Terms

*Trend 10, Private Equity Transaction Structures, continued...*

- Opportunity for “2 Bites at the Apple” by Sellers and equity appreciation by key executives
- Subordinated Notes – payment terms and subordination provisions may be among most heavily negotiated items
- Rollover Equity – usually *pari passu* to or one level behind sponsor and subject to shareholders agreement
- Management fees and transaction fees paid to sponsor

# Trends in Defense M&A Terms

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## Conclusions:

- Prevailing trends can be helpful to provide guidance in formulating party's negotiating strategy
- Resulting terms reflect the particular circumstances, bargaining power and practices of the parties involved
- Experienced financial, legal and accounting advisors can assist in developing creative compromises