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

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About Holland & Knight

- 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
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• 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

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• 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
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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
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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
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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
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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
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**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
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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
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**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
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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

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**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
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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
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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.
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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
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**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
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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

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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.
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**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.

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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
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**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
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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
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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

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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

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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 *parri passu* to or one level behind sponsor and subject to shareholders agreement
- Management fees and transaction fees paid to sponsor
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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

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