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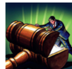

BY PATRICK J. DOOLEY

LESSONS LEARNED

DESPITE A CREDIT CRUNCH, M&A WILL CONTINUE, ALBEIT WITH LESS LEVERAGE AND GREATER SENSITIVITY TO PRICE

While speculation about future merger and acquisition activity is always an uncertain undertaking, by looking at some of the key developments in 2007, it may be possible to anticipate some likely trends for 2008.

At the macro level, one of the biggest factors likely to affect M&A activity is the continued credit crunch in acquisition financing. Private equity transactions require leverage. Since mid-2007, the ability of banks to syndicate their acquisition loans has been substantially reduced. As a result, financing for already-signed deals has slowed, and some may not be completed. For 2008, the inability or unwillingness of banks to lend for leveraged acquisitions will likely result in a slowdown of activity.

PE buyers will need to add more equity for proposed transactions. This will reduce the rates of return on the transaction for the fund, which will reduce the price the fund is willing to pay and the attractiveness of acquisition proposals to target companies.

Other sources of equity capital that are less dependent on leverage, such as sovereign wealth funds and special purpose acquisition vehicles, may fill the gap, but these capital pools have inherent differences from PE funds that may make them less effective drivers of public M&A activity than the private equity funds.

Where PE-driven acquisitions do get signed up, the terms the target board exacts may become less buyer-friendly. One of the principal differences between a strategic buyer and a private equity buyer has been that a PE buyer is unwilling or unable to put its balance sheet behind its commitment to complete the acquisition transaction. The typical PE acquisition structure involves newly formed shell companies, and the PE fund is liable only for a relatively small reverse breakup fee in the event the transaction does not close. Through 2007, target boards were willing to accept this structure for a number of reasons. A breakup fee, while not big enough to compensate the target for the deal failing, was big enough to give some comfort that the PE buyer would not cavalierly walk away from the deal. And in many cases, the only other bidders likely to be competitive on price were other funds with similar constraints.

There was also a long-held belief by targets that the reputational damage to a fund that failed to complete a transaction acted as a deterrent to willfully failing to close. Over the past six months, there have been several notable examples of PE funds that have walked away from signed transactions. In the future, companies will likely be more sensitive to completion risk and seek to negotiate more effective protections to address this concern. The size of reverse breakup fees (or minimum capitalization requirements for the shell companies) may increase, or companies may seek direct enforcement rights against financing sources. Whether boards will be successful in extracting such enhancements remains to be seen.

> THE FUTURE MIGHT FIND STRATEGIC BUYERS INSISTING ON LIMITING THEIR LIABILITY TO THE SAME EXTENT AS THE FINANCIAL BUYERS.

The recent experience of PE funds electing not to proceed may also give a competitive advantage to strategic buyers or investor groups that are prepared to put their balance sheets behind their contractual commitments under a merger agreement.

Price will still be the principal factor in choosing a winner in a bidding process, but confidence that the deal will close will take on added importance. A savvy strategic buyer may well be able to pay less than a financial buyer that needs to limit its liability for a failure to close or become the favored bidder, since it offers an equivalent price with less perceived completion risk. Alternatively, the future might find strategic buyers insisting on limiting their liability to the same extent as the financial buyers they are competing with if they fail to close.

Recent experience may also lead to more precision in the way transactions are structured and documented. The recent United Rentals Inc. litigation, which sought to require the acquiring entities to perform their obligations to obtain financing and ultimately close the merger, was in part a function of the lack of precision in the language of the merger agreement itself. While there are often reasons parties elect to live with imprecision in acquisition documentation, the high stakes apparent in these cases suggest that the wording of merger agreements will be carefully addressed during negotiations.

Overall, M&A activity will continue in 2008, but it may be at a reduced level and with transactions structured to address the issues that first appeared in late 2007. ■

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