# Newsletter
# November 2015

## MobileSolve Group

***Mergers & Acquisitions***

***Capital Raising***

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MobileSolve is a boutique investment bank providing M&A, capital raising and financial advisory services to companies in the Telecom, Wireless, Internet, Networking and Semiconductor industries.*

Each month we present a short article on an industry or transaction topic of current interest, and notable transactions in our industries completed during the prior month.

This month's newsletter is about the significance of signing, of the Letter of Intent ("LOI") in the bidding process of purchasing a company. We welcome your questions or comments.

To comment or subscribe, email steve.gaynor@mobilesolve.com

## Deal Structuring in the Letter of Intent

**By: Steve Gaynor, Neeraj Baghel and Mansi Srivastava**

A well-run sell-side acquisition process generates competition among bidders to maximize price and to get good terms. That is achieved because competition produces leverage from playing off one buyer against another. The leverage largely dissipates upon the signing of a Letter of Intent ("LOI") to purchase the company.

In the LOI, the seller typically grants the purported buyer exclusivity for an agreed period of time to complete due diligence and to agree to definitive transaction documentation. This grant, embodied in the so-called "no-shop" clause, effectively ends the competition and thereby the seller's leverage.

That would be fine if the LOIs dealt with all of the issues the seller will face through the life of the deal. But they typically do so up to a point; that is, through the closing of the transaction. Few LOIs deal with the risks sellers face after the closing that are defined in the definitive documentation.

Commonly covered items in the LOI include purchase price, transaction structure (i.e., the mix of cash, stock, seller financing, and earnout, if any), terms, employment matters, and closing contingencies. However, the LOI typically fails to address the key issues that can trigger a post-closing adjustment to the sale price.

To minimize the post-closing financial risk assumed by the seller, these issues should be addressed at the LOI, when the seller still has leverage over the buyer resulting from the competitive bidding process. Failing to do so risks obtaining less than the best possible terms.

There are three post-closing potential financial adjustments that can occur. They are (i) net working capital ("NWC") adjustments, (ii) earnout payments and (iii) claims against escrowed funds.

***Net Working Capital Adjustments***

Transactions are generally structured on a "cash free, debt free" basis. In effect, the buyer acquires the "normal" level of current assets and liabilities for the business (i.e., the working capital), and the related fixed assets, but does not assume any long term debt unless it is specifically agreed as part of the purchase price by the terms of the transaction.

At the closing, any increase in the "normal" level of NWC (current assets less current liabilities) increases the purchase price dollar-for-dollar, with the reverse triggering a decrease. The seller remains responsible for retirement of the long term debt.

To implement this scheme, because NWC changes daily, there must be agreement on the "normal" level of NWC in the ordinary course of business. Once the closing balance sheet is determined, adjustments are made to bring the actual level of NWC as of the closing date to the agreed level.

The agreed level of NWC may be figured in several ways. A popular method is to make an historical analysis of NWC, and determine the amount that reflects normal operating balances over a multi-month period of time. This ought to remove any short term variations due to temporary conditions or seasonality.

Sellers should make sure they understand and approve the methodology that will be used to calculate the agreed closing level of NWC prior to signing the LOI. The methodology should allow them to comfortably manage the working capital to deliver close to the agreed level at the closing, and thus to avoid a sharp price reduction.

***Earnout Payments***

Although sellers prefer to avoid earnouts, they are often included in smaller, private company transactions. Buyers tend to use them as a risk reduction tool, but they can also benefit sellers to reduce a valuation gap between the parties and reach an agreement.

Because earnout periods often endure as long as three years, in addition to being potentially the largest price adjustment, the earnout is also the longest lasting price adjustment barring outright violation of a material representation or warranty. Not surprisingly, they are generally the subject of heated negotiation and sometimes dispute in how they are to be calculated.

Calculation of earnout payments are usually complicated and thus difficult to negotiate. It is likely only a few general guidelines can be negotiated at the time of the LOI, with additional details to be determined in drafting the definitive documentation. These guidelines can nevertheless be valuable for the seller going into negotiation of the actual purchase agreements. They should cover these issues:

- *Performance Measures*: A seller should only accept performance measures over which she has some control of the outcome. Top-line revenues are generally used, and usually accepted by both parties. Profitability measures such as operating income, EBITDA or cash flow should be used only if the seller has control over expenses.
- *Flexibility*: Meeting a specific performance goal that carries a major purchase price adjustment can create problems if it is inflexible. The seller will quite naturally manage to the performance goal, letting

other important operating or financial metrics suffer. Concepts of flexibility and scaling related to the financial goals should be introduced so any purchase price adjustment is commensurate with the actual performance achieved post-closing.

- *Scope*: If any item is to be excluded from an earnout, such as sales to certain customers, then the seller will do well to have the buyer identify them at the LOI when he will be more conservative in attempting to reach an agreement. At this stage, it is possible to have no items excluded from the earnout.

Guidelines or more expressed in the LOI will help the seller achieve more favorable terms in the final purchase documentation.

### ***Escrow Claims***

An escrow is an amount held back from payment of the purchase price to the seller (and is often called a "holdback") to satisfy liabilities that cannot be determined at the time of closing. Often the nature or amount of the liabilities is unknown, but sometimes the escrow is also used to handle a known contingent liability. When all claims against escrow are resolved, the escrow is released, and the amount that remains is paid to the seller.

The usual practice is to address the details of the escrow when the definitive documentation is negotiated. That's primarily because the buyer wants first to conduct sufficient due diligence to identify the types of risks and possible amounts involved to ensure they are covered by the escrow.

The parties subsequently vigorously negotiate the terms as the buyer seeks access to the escrowed funds for its claims to avoid the more expensive alternative of legally pursuing the seller to satisfy them, while the seller seeks to avoid giving the buyer a blank check to recoup a portion of the purchase price.

While it is in the interests of both parties to agree in advance on the events or findings that would generate a claim against the escrow, the seller can improve her position by negotiating those terms to the extent practicable at the LOI, when, again, her leverage is greatest. The key terms to negotiate are:

- *Escrow Amount*: General practice calls for a holdback of 10-15% of the purchase price available to offset potential claims stemming from the ordinary representations and warranties that may arise after closing.
- *Scope and Caps*: The losses that may be recovered, and limits on potential recovery.
- *Duration*: The amount of time following the closing when buyers may submit claims against the escrow. The typical duration, also called the survival period, is one to two years.
- *Indemnification Threshold*: The minimum level of potential losses from claims made by the buyer before making a draw against the escrow. Having a threshold of 10-20% of the escrow amount can avoid post-closing disputes.

In conclusion, it may be difficult to bring forward to the LOI negotiation key terms typically negotiated when the definitive documentation is drafted. The buyer understandably will be reluctant to agree to certain terms prior to completion of its due diligence. Nevertheless, a seller should attempt to include as much as it can involving the three areas described above while its negotiating leverage is greatest. That time is while a competitive bidding process has produced several interested potential buyers, and before their involvement is ended upon signing the LOI's "no-shop" clause.

Sources: MobileSolve Analysis

Note: This newsletter if for informational purposes only, and not for the purpose of providing legal, financial or other advice



## More Articles

In case you missed any of our previous articles, below are the links to them.

***Equity CrowdFunding - A Potential Revolution in Financing Startup***
***Enhancing Your Company's Valuation***
***Berlin, Paris and London: VC Capitals of Europe***
***Don't Blow the Closing***
***Positioning for Series A***
***Does A+ make the Grade?***
***Earnouts: Treacherous Territory for Sellers***
***Global M&A in 2015***
***Love and Venture Capital***
***Don't Sign that NDA!***
***Fees in the VC Industry***
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*Comments and Questions on the above articles are welcome.*
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# Transactions

The following are notable M&A transactions and capital financings announced or completed in the last month.

### Notable **M&A Transactions**

| Target | Target Industry | Acquirer | Transaction Value (in $ millions) | Transaction Highlights |
|---|---|---|---|---|
| ALLO Communications | Telecommunications | Nelnet | $46.25 | ALLO Communications is a company offering local telephones & broadband connections to residents & businesses across Western Nebraska. |
| Cable & Wireless Communications | Telecommunications | Liberty Global | - | Cable & Wireless Communications continues to be at the forefront of delivering world-class telecommunications to meet growing customer demand. |
| Fairchild Semiconductor | Semiconductors | ON Semiconductor | $2400 | Fairchild Semiconductor offers power analog, power discrete, & non-power semiconductor solutions. |

| | | | | |
|---|---|---|---|---|
| Golan Telecom | Telecommunications | Cellcom Israel | $301 | Golan Telecom is a mobile operator in Israel |
| GROUPME | Mobile Messaging | SKYPE | $85 | GroupMe is a group mobile messaging service for finding, planning and purchasing group activities. |
| King Digital (Candy Crush) | Mobile gaming | Activision-Blizzard | $5900 | Candy Crush Saga" creator King Digital Entertainment - which develops gaming applications |
| Mobile Data Labs | Mobile Application | Microsoft | - | Mobile Data Labs, Inc. provides MileIQ, a mileage-tracking mobile application |

## Notable **Capital Financings**

| Company Name | Industry | Amount Raised (in $ millions) | Total Amount Raised (in $ millions) | Business Description |
|---|---|---|---|---|
| AppDome | Mobile Security | $13 | - | AppDome's dynamic wrapping SaaS technology provides an essential shield that secures consumer-facing apps from advanced cyber threats |
| Chargifi | Mobile Infrastructure | $2.7 | - | Chargifi provides wireless charging spots that enable venues to offer wireless charging services through Wi-Fi. |
| GoodBox | Messaging App | $2.5 | - | GoodBox is a messaging app for small & large businesses to reach out to a wider audience.<br>The company will soon enable payments on the platform, allowing users to place orders directly on the app |
| PayTunes | Mobile Advertisement | - | - | PayTunes is a Mobile advertisement platform company |
| POKKT | Mobile Advertisement | $5 | - | POKKT is an Alternate Mobile Payment Platform that helps owners of Paid Digital Goods & Services to monetise thier users through an advertiser-funded Model |
| Perfecto Mobile | Hardware & Software solution | $35 | - | Perfecto helps you your strengthen every digital interaction with a quality-first approach to creating web and native apps. |

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**Email:** steve.gaynor@mobilesolve.com

**www.linkedin.com/in/stevengaynor**