Chapter 5 Late-Stage Framework -- Part 2 of 3

5.1 Environment and Context:

I will not belabor again the importance to forward looking assessments of perceptions of anticipated external economic, market, social, and political factors. To stimulate your thinking, consider asking:

- What aspects of context have been most relevant to the target's historical performance and how can they be quantified?
- What are the historical statistical relationships among performance metrics for the target and those measures of context? What, for example, has been the relationship between unit sales growth and GDP growth?
- Is there reason to believe that those relationships should continue?
- What is the strategic posture of the business? Considering Harvard Professor Michael Porter's five forces can be helpful, especially with more mature companies.[37] Very briefly, to refresh your memory, they are: competition in an industry, potential new entrants, supplier power, customer power, and substitution threats.
- How is the target's context likely to change over the intended investment horizon? What could be surprising on the up and the downside? For example, are you in a period of broad economic growth, high inflation, radical technological transition, important demographic change, or political turmoil? Is recent favorable performance largely a function of a robust economy or macroeconomic liquidity that will likely regress to the mean?
- How should these insights best be captured in the design of scenarios?
- How is the target structured to perform in these different environments?
- What is the condition of the financial markets? Are debt and equity capital readily available or scarce? How are they expected to change? How should capital market considerations affect the design of the target's capital structure and exit expectations?
- How highly regulated is the business?
- What are the points of political power in the country in which you plan to invest and what is the relationship of the industry, company, or target management to them?
- Is the rule of law subordinate to political control in the country in which you will be investing or to which a business is materially exposed?

[37] See by Michael Porter either *Competitive Advantage: Creating and Sustaining Superior Performance* or *Competitive Strategy: Techniques for Analyzing Industries and Competitors*.

- Can you do business in the country of interest and still comply with your, and your limited partners', ethical and legal standards concerning, without limitation: corruption, transparency, social justice, environmental stewardship, market regulation, and currency transfer restrictions?

5.2 Immitigated Risks and Uncertainties

The purpose of this element is to ensure the recognition of critical immitigated risks and, if an investment is made, that processes are established to recognize, collect, and analyze missing information. (Again, I realize immitigated will be flagged by AI as an archaic term. I am intentionally using it to emphasize the point that some issues cannot be mitigated.)

The next framework topic – return drivers -- focuses on planning how to act on that information. To reiterate, satisfactory private equity returns are not achieved without the assumption of risk – the acceptance of information gaps. They can exist in any dimension of this framework.

- Throughout the analysis, structuring, and post-closing stewardship of an investment, regularly consider how best to identify immitigated risks, inventory them, develop methods for addressing them, prepare to respond when new data is available, and follow through – mitigate them.
- Distinguish between company and systematic risks.
- Work to quantify the likely range of costs (or benefits) latent in each immitigated risk.
- Assign probabilities to potential outcomes. Be mindful of the heuristic tendency to overemphasize the likelihood of unlikely but harmful events.
- Recognize that real costs and benefits are often neither normally distributed nor linearly scaled.
- Be aware of immitigated risks embedded in assumptions that are taken for granted which, if not sustained, can destroy value. For example, do not assume that the research and development efforts of mature companies will suffice to maintain their competitiveness.

5.3 Return drivers

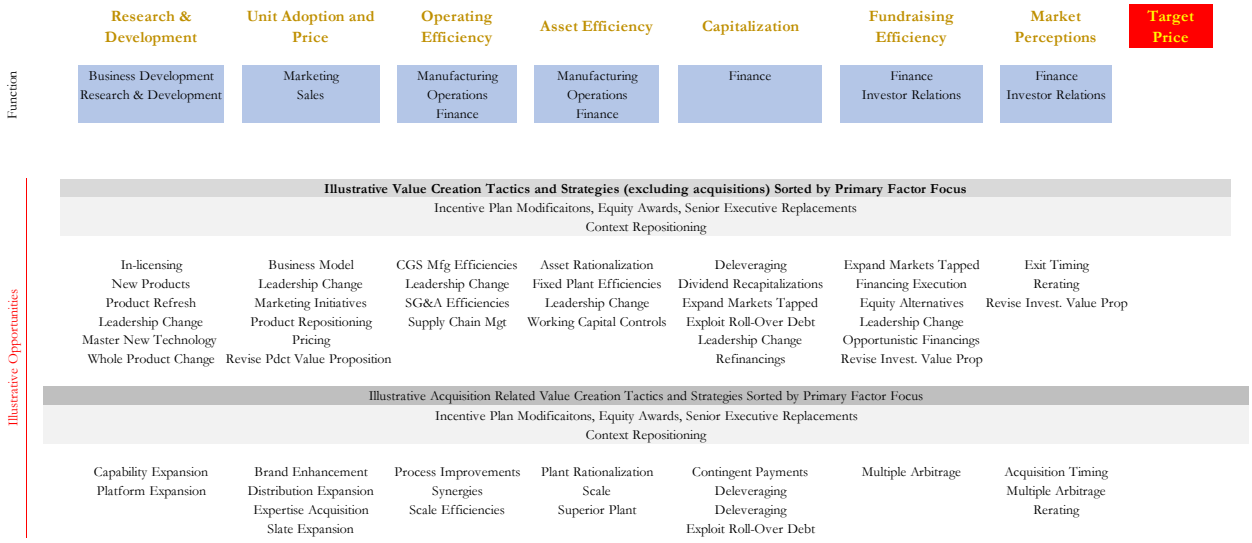
Return drivers are the factors, and actions within them, that are anticipated to have the greatest impact on forecasted returns. The Factor Value Chain schematic introduced in Book 1 is reproduced again below in Figure 5-1 together with an illustrative list of actions owners often take within each of them to generate value and redress immitigated risks. The list is long and important. Take a few minutes to consider each of them.[38] An investment can have more than one return driver.

[38] Included among them are the sorts of Big Moves to which Bradeley et. al. of Mckinsey refer in *Beyond the Hockey Stick,* discussed in Book 1.

The business functions likely to implement or be affected by the value creation initiatives are arrayed across the bottom of Figure 5-1. They should not be construed dogmatically. Initiatives often require the integration of efforts and have affects across multiple functional areas.

Recognizing return drivers will help you to focus your investment assessment and post-closing priorities, to align those priorities with a management team and any co-investors, and to communicate effectively with investors. They are at the heart of investment value propositions and, as such, they explicitly or subliminally can frame expectations. Be aware of whether you have adopted a counterparty's description of an investment's return drivers or defined your own.

Figure 5-1
Illustrative Factor Value Chain Value Generation Opportunities



Immitigated risks and return drivers are often reflections of one another. This is sensible. Investors should be rewarded for the assumption and mastery of immitigated risks.

It is not redundant, however, to consider return drivers and immitigated risks independently. Immitigated risks are gaps in knowledge – often acknowledgments of what cannot be known. Drivers of return are more action oriented -- steps that can be taken or events that are anticipated.

Students sometimes erroneously describe return drivers as exits. They are not synonymous. Exits are paths to value realization. How well or poorly exits are accomplished will affect realized values, but it is return drivers, not the quality of exit execution, that will usually generate most of the value realized.

5.4 Exit Possibilities

The purpose of this framework element is to ensure that you focus on how an investment is likely to be realized (sold) and how its value, net of fees, will be returned to limited partners. Selling well is a powerful driver of late-stage private equity performance.[39]

Since cash is what limited partners deliver to fund their private equity capital commitments, exits should refer to cash generated from portfolio investments and distributed by private equity funds to their limited partners. In practice, however, general partners have stretched the definition of what constitutes an exit and thus muddled the concept. The different transactions and value transfers discussed below are all commonly referred to as potential private equity exit routes. As you shall see, if an exit must deliver cash, some of the events listed below would not qualify. For example, sponsors sometimes have portfolio companies undertake initial public offerings of primary shares to enable follow on underwritten offerings or open market sales of their ownership positions. As discussed below, such IPOs are often labeled as exits but, in fact, are not realization events.

No one exit path may be certain, so, in general, the more routes that an investment might follow, the better. The viability and relative merits of different routes shift with markets. No one path to cash may be certain. In evaluating which exit routes might be applicable to an investment, there are a number of attributes to consider. Some routes, for example, will involve a single transaction, such as a sale to a strategic buyer; whereas, others may involve a series of transactions (such as open market sales of blocks of shares). If, for example, a country in which an investment is being made is likely to impose restrictions or taxes on repatriations of returns, the issue should surface here. At least the following eight characteristics should be considered for any exit route might be applicable to an investment:

- Time to the exit
- Enabling actions or transactions that may need to occur first such as a primary share IPO
- Probability weighted range of values it is likely to yield
- Size of a position that might be sold at one time (liquidity)
- Form of consideration it is likely to yield (cash, liquid securities, or illiquid securities)

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[39] Conceptually, this should be clear from your earlier modeling exercises. Empirically, Daniel Rasmussen, the manager of Vervad, a hedge fund predicated on investing in small-cap leveraged stocks, told the *New York Times* in 2018 that researching private equity returns when he was an analyst at Bain he found "the cheapest 25 percent of deals accounted for 60 percent of the funds' profits. The top 50 percent accounted for just 7 percent of profits. The difference was the price paid for the company." Frustratingly, the *Times* did not define the study population more precisely and neither Rasmussen nor Bain appear to have published the study, so I will confine this reference to a footnote. [Paul Sullivan. "A contrarian urges caution on investments." *The New York Times International Edition.* September 17, 2018. P. 11.] See also a study by *Pitchbook* that reaches a similar conclusion in a correlation between cyclical private equity returns and ebitda entry multiples. https://files.pitchbook.com/pdf/PitchBook_2017_Analyst_Note_Exploring_Buyout_Multiples.pdf

- Changes in sponsor control that pursuing it will cause and the implication thereof
- Execution costs
- Continuing post-exit obligations or liabilities.

Over time, the two most prevalent exit routes for late-stage private equity investments have been merger and acquisition transactions (through so-called "strategic" sales to industry buyers or through sales to other financial buyers) and sales into public markets following initial public offerings.

Other routes to value realization have included Direct Listings, sales to Special Purpose Acquisition Corporations (SPACs), sales of unregistered shares, distributions in kind, dividend recapitalizations, and, for the unfortunate, liquidations and wind-downs. The following sections discuss these routes in more detail.

5.4.1 Merger and acquisition transactions involving sales of all shares or assets

The sale in a single transaction of portfolio company's shares or assets is generally a preferred route of exit. In a survey of 79 major late and growth stage private equity firms by Paul Gompers, Steven Kaplan, and Vladimir Mukharlyamov (of the Harvard Business School, University of Chicago, and Harvard University respectively) for example, approximately 80% of exits were reported to have been via changes of control.[40] Such change of control transactions are generally achieved at prices that are at a premium to public trading values, and, after the satisfaction of closing conditions and the release of escrows, yield complete liquidity, and an end to continuing liabilities. From time to time, though, speculators do drive trading valuations to levels that exceed the appetites and capacities of change of control buyers.

Included in this exit route will be sales to:

> companies with a strategic interest in acquiring a target (so called strategic buyers) which may be publicly or privately held companies, including companies controlled by sponsors (about two thirds of the change of control exits reported by Gompers et. al. were to strategic buyers) and,
>
> other private equity funds (referred to as financial buyers) making a fresh capital commitment rather than funding an acquisition by an existing portfolio company. These are sometimes referred to as secondary financial buyers. These accounted for the other third of the change of control exits reported by Gompers et. al.

5.4.2 Initial public offerings (IPOs)

Equity interests may not be sold to the public in the United States unless they are registered with the Securities and Exchange Commission (SEC) or are exempt from registration under the SEC's rules

[40] Gompers. 2015. Ibid. Table 27.

and regulations.[41] First sales of registered shares to the public are referred to as initial public offerings (IPOs).

In recent years, most IPOs have involved the sale of only new (primary) shares, not sales of shares by pre-IPO holders (secondary shares).[42] Thus, they have not been a direct route of exit. In the minority of IPOs that include secondary shares, the preponderance of the shares sold were primary (70% in the footnoted reference). On average, then, it is misleading to construe IPOs as a frequent exit mechanism. Nevertheless, lacking access to accurate actual exit data, academic studies often do. Sponsors eager to benefit from IPO pricing as a basis for marketing follow-on funds will use them to mark their unsold positions, treating them inferentially as exits.

One can speculate as to why IPO investors might prefer to buy primary as opposed to secondary shares (e.g., they prefer to see their capital deployed in a business rather than carted off by insiders) but, for our purposes, what matters are the empirical findings. Investment bankers, eager to stay within norms that apparently satisfy the preferences of IPO investors will follow these statistics and, unless demand is exceptional, discourage the inclusion of secondary shares in IPOs. In any event, for 180 days following an offering, the underwriting agreements that enable IPOs impose restrictions (lockup agreements) on sales of pre-IPO holder shares rather than facilitating them.

What IPOs do accomplish for pre-IPO holders is to enable exits following the expiration of lockup agreements. IPOs make portfolio companies visible among investors and analysts and place them in an ecosystem of brokers and dealers eager to facilitate secondary share sales through open market sales and follow-on secondary share underwritten offerings.

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[41] For more information on the legal documents and issues involved, see, for example: Latham and Watkins. *US IPO Guide 2020 Edition.* [https://www.lw.com/thoughtLeadership/lw-us-ipo-guide] Practical Law's *Initial Public Offerings Toolkit* (2-578-7625). https://uk.practicallaw.thomsonreuters.com/2-578-7625?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1

[42] Wilmer Hale, a law firm with a large IPO practice, for example, reported in 2015 that for the period 2007-2014, 55% of all IPOs consisted only of primary shares. [Wilmer Cutler Pickering Hale and Dorr. 2015 IPO Report. p. 9.] Wilmer's study did not distinguish between sponsor and non-sponsor-backed issuers.

The NVCA estimates that approximately 45% by number of all IPOs in the period 2000-2014 were of venture sponsor-backed companies. The remainder were IPOs of later stage companies, such as lbo exits or privatizations; offerings of divisions of later stage companies; or offerings by early-stage businesses that managed to succeed without sponsor capital. Since early and growth stage companies are more likely to require capital to fund their operations than later stage companies (excluding lbo's raising capital to de-lever), it may be reasonable to expect that the portion of early-stage IPOs involving secondary shares, and the share of total shares when they are included, would both be less.

Similarly, a 2007 study of 4,219 IPOs completed from 1980-2001 found that 56% were of primary shares alone. In the remaining portion that included secondary shares, on average, 72% of the shares sold were primary. [see James C. Brau, Mingsheng Li, and Jing Shi. "Do secondary shares in the IPO process have a negative effect on aftermarket performance? *Journal of Banking & Finance.* 31:2007. 2612-2631. p. 2617.]

In recent years, the number and dollar volume of follow-on offerings has generally been three times that of the IPOs that have enabled them.[43] Underwritten follow-on offerings may consist purely of secondary shares or combinations of primary and secondary shares. Their feasibility will vary with market conditions but, in general, they can facilitate more orderly sales of large inside positions than uncoordinated offerings by multiple holders or the presentation to an unprepared market of an enormous block position. The transaction and documentation costs of underwritten follow-ons will be greater than open market transaction costs, they may trigger tag along rights, and, if they often impose underwriting lockups on unsold shores.

Of course, IPOs also raise capital for their portfolio companies which can be used to de-lever or grow them. And, late-stage sponsors may also use IPOs strategically to establish values for portfolio companies against which subsequent change of control sales can be priced.

In any case, IPOs will not be undertaken lightly. They are expensive and disruptive to complete and create significant long-term reporting, fiduciary, and shareholder relations obligations. In the medium term, they will also create pressure on late-stage sponsors to sell. Holding a large liquid position in a private equity fund may be criticized as operating outside of a fund's mandate. Limited partners will also likely object to paying private equity level fees on publicly traded shares that could be managed for much less.

Since the passage of the Securities Act of 1933, IPOs have been subject to substantial Federal, State, and complementary trading exchange regulations. Established in the wake of unscrupulous behavior by issuers and their agents prior to 1933, it is meant to balance the capital raising needs of legitimate issuers with the interests of investors and is based on the legal enforcement of essentially four principles: mandatory disclosures of material information concerning the issuer and the offering; a mandatory pre-offering review by the SEC of a core offering document (the prospectus); restrictions on the selling processes sufficient to "give the disclosures sufficient potency to generate informed investment decisions;" and, finally, the assumption of liability by issuers and their agents for their support of the first three principles.[44] Significantly, even though investment decisions must turn primarily on forward looking judgments, the focus of mandated IPO disclosures and disclosure liability is on information that is primarily backward looking. Issuers are required to disclose potential sources of investment risk and known trends and uncertainties but not to quantify their impact or probabilities. "In sum," Professors Langevoort and Thompson, of Georgetown University Law Center have written

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[43] PWD Deals Practice. *2018 US Capital Markets Watch.* https://www.pwc.com/us/en/services/deals/library/us-capital-markets-watch.html

[44] For a discussion of these principles and the evolution since 1933 of their embodiment in the law, see: For a discussion of the history and range of such exemptions see, for example, Robert B. Thompson and Donald C. Langevoort. "Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising." *Cornell Law Review Symposium: Law, Innovation, and Entrepreneurship*. 98:6 September 2013. Article 7 and Robert B. Thompson and Donald C. Langevoort. "IPOs and the Slow Death of Section 5." *Georgetwon University Law Center.* 2013 https://scholarship.law.georgetown.edu/facpub/1271. The quotation is from the former, p. 1575.

> what the statutory prospectus reveals to whoever chooses to read it is not necessarily the whole story about the issuer. The SEC has deliberately restricted the duty to speak to the future, and *discourages* IPO issuers from doing so publicly, even if they want to.[45]

There are many excellent reviews of the legal aspects of IPOs. There are fewer on their transactional mechanics, so I describe those in Book 4. The next section describes so-called UP-C IPOs. Sponsors often use them to squeeze more value out of IPOs.

5.4.2.1 Umbrella Partnership – C-corporation Initial Public Offerings (UP-C IPOs)

Expanding conceptually on tax provisions originally intended to pertain to the real estate industry, over the past 20 years specialized lawyers, accountants, and financiers have developed a structure for initial public offerings that generates tax benefits unavailable pursuant to traditional IPOs. They are referred to as UP-C IPOs and are illustrative of the lengths to which sponsors and their advisors will go to discover and engineer advantageous transaction structures..[46]

The supercharged tax benefits of UP-C IPOs are so compelling, BYU Law School Professor Gladriel Shobe concluded in an analysis of them, that one should wonder not

> why owners … choose to supercharge an IPO [but, rather] why they would ever choose *not* to supercharge an IPO when the UP-C structure is available.[47]

Like many tax structures, UP-C IPOs are a bit arcane. To begin, they are applicable only to partnerships or a similar pass-through corporate entity taxed as a partnership, such as a limited liability company (LLCs).[48] This is important, because it favors the initial structuring of sponsor investments

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[45] Langevoort. 2013. Ibid. p. 37. Congress, they continue in a footnote, has reenforced this preference by creating a safe harbor for forward looking statements by existing issuers but not in IPOs. Securities Act Section 27 A(b)(2)(D), 15 USC Section 77aa-1(b)(2)(D)

[46] Deloitte reports, for example, that, in the ten-year period of 2005-2015, 55 companies raised approximately $30 billion through UP-C IPOs, of which two-thirds were controlled by private equity sponsors. J. Lynette DeWitt. "Positioning for Success in Private Equity: The UP-C Advantage." *Closer Look. Deloitte.* Deloitte Center for Financial Services. 2015. p. 1.

[47] Gladriel Shobe. "Supercharged IPOs and the UP-C." *University of Colorado Law Review*. 88:2017. p. 947.

[48] Basically, income taxes are not paid at the level of a partnership. Rather, the income is passed through to the partners (or LLC members) and attributed to them as ordinary income. Thus, partnerships can distribute income to the partners that, unlike the dividends of taxable corporations, are taxed only once, at the partner level. Interested readers will find numerous references on the taxation of partnerships and LLCs including, for example, Practical Law's Practice Note W-000-6885. There are opportunities for partnerships to become publicly traded entities as well and to capture tax benefits similar to those described for UP-C's, but, the law permitting them is sufficiently restrictive to cause UP-C's to be a favored structure. The IPOs of private equity sponsors organized as partnerships, such as Blackstone, Carlyle, and KKR availed themselves of these benefits and attracted Congressional scrutiny. "The roots of [proposals to eliminate the applicability of such benefits to private equity fund sponsors], Victor Fleischer reported for the *New York Times,* "go back to the summer of 2007, when the Senate introduced legislation that would have had similar effect. The bill became known in some circles as the 'Blackstone Bill' or the 'Birthday Party Bill' in reference to the outrage some felt about an extravagant birthday party

as LLC's or partnerships – the end dictates the beginning. To understand how they work, consider the following example

> Assume that a sponsor has an investment in a partnership operating entity (OP).[49] To prepare for an UP-C IPO, a new C-corporation is formed (PubCo). It is the common stock of PubCo that will be sold to the public. With the proceeds of that IPO, PubCo will buy partnership interests directly from OP or from the sponsor that owns OP.
>
> Two sources of tax value are created by the UP-C structure.
>
> One results from the preservation of the pass-through income taxation for the sponsor at OP. Were OP recapitalized as a C-corporation in anticipation of an IPO, as would traditionally be the case, future distributions by it of cash to its owners in the form of dividends would be taxed first as income at the C-corporation level and then again as dividend income for a sponsor's limited partners (recall that private equity funds are pass through limited partnerships). At 2017 tax rates, Shobe estimates the resulting federal tax savings to be up to 10.9%.[50]
>
> The other source of tax value results from the tax treatment of OP partnership interests acquired by PubCo. Pursuant to Section 754 of the tax code, PubCo will set its tax basis (the measure of cost against which future gains are calculated and taxed) in the OP interests it acquires based on the purchase price PubCo pays for them. While the historical basis (the one OP has in its assets) will relate to the capital invested in it; the purchase price paid by PubCo will reflect the value attributed by investors to OP's prospects. In the case of a successful investment this perception of future value will be greater than the historical cost. This difference is sometimes referred to as positive goodwill. Importantly, the tax law permits the increased basis to be deducted against PubCo's reported income over the 15 years following its acquisition of the OP interests.[51] Thus, the UP-C process makes any gain in the value of OP relative to its historical cost (the positive goodwill) a deductible expense that reduces taxes paid on income passed through from OP to PubCo.[52] In theory, this new-found source of deductions should create value in PubCo equal to the present value of the reduced taxes.

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held by Stephen Schwarzman, the chairman of the Blackstone Group." [Victor Fleischer. "The So-Called Blackstone Bill Resurrected." *The New York Times Dealb%k.* February 27, 2014.]

[49] This nomenclature is adopted from a description of UP-C's written by lawers from Simpson Thacher & Bartlett. Joshua Ford Bonnie and William R. Golden. "UP-C Initial Public Offering Structures: Overview." *Practical Law.* Resource W-009-1403. 2018. Thompson Reuters. A number of important mechanical issues have to be dealt with in establishing OP – such as setting the number of its common shares to correspond with the proportion of the OP interests it will require and ensuring that the owners of OP have proportional control of PubCo – but I will leave those beyond the scope of this discussion and focus on the critical underlying economics. See, for example, Shobe, Ibid; Bonnie, Ibid; or DeWitt, Ibid.

[50] Shobe, Ibid. p. 944.

[51] Shobe.Ibid. p. 929 note 66. Reference to Internal Revenue Code 197(a), (d)(1)(A) pertaining to deductions of goodwill.

[52] A C-corporation can also step up its basis in the course of an IPO through an election under Section 338(h)(10). But, in that case the shareholders are deemed to have sold their shares at the time of the election and become liable for a tax on any capital gain. Through a UP-C structure, no taxable gain is recognized by an OP owner until their interest is actually sold.

> But there is one more critical element of most UP-C agreements that transfers most of this value to the original owners of OP – in the example being discussed, a private equity sponsor.
>
> When PubCo is formed, it enters into a Tax Receivable Agreement (TRA) with the owners of OP. Pursuant to the terms of the TRA, PubCo agrees to pay to the OP owners a proportion (in most cases 85%) of any tax benefits realized by PubCo from the amortization of the step up in basis in OP interests PubCo acquires. Thus, by exploiting a provision of partnership tax law concerning basis adjustments upon the sale of partnership interests, the UP-C structure enables an OP owner to capture a tax benefit through TRA payments that otherwise would not exist for them pursuant to a traditional IPO.

UP-C's may not endure. Shobe, for example, finds "the structure used in the UP-C conflicts with both congressional intent and the regulations that supposedly allow it."[53] As of this writing, Congress has twice considered, but not moved, to disqualify their benefits.

5.4.3 Direct Listings

Critics deride traditional underwritten IPOs executed by investment banks for their cost and what they perceive to be their inefficiency.[54] Nevertheless, the process has proven remarkably durable. A few notable alternative offering processes, however, have been undertaken that could presage change. Interestingly, they all involve substantial numbers of secondary shares and thus serve as exits for many.

In 2004, Google went public through a Dutch Auction. Roughly a third of the shares were secondary. Relying on the order matching capabilities of exchanges rather than a Dutch auction process, in April 2018 Spotify went public through what was called a direct listing on the NYSE and in June 2019, Slack followed suit. Both offerings were entirely comprised of secondary shares. Importantly, while they established a market for the secondary shares, they did not guarantee any trades. No proceeds were guaranteed to any selling shareholder as they would be in an underwritten offering of secondary shares.

The absence of primary shares was a result of regulatory restrictions on their inclusion. In 2020, however, the SEC issued orders enabling the NYSE to broaden the utility of direct listings by enabling their inclusion of primary as well as secondary shares.

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[53] Shobe. Ibid. p. 942. See also Debevoise Plimpton "The UPC Goes to Court. Managing the Energing Risks of an Advantageous Tax Structure." May, 2023. https://www.debevoise.com/insights/publications/2023/05/the-up-c-goes-to-court

[54] The measure of efficiency on which they focus is usually the difference between an IPOs offering price and initial trading price. From time to time, these differences can be substantial. Often lost in the criticism, however, is the minority amount of total shares sold as a percentage of the total outstanding, the number of instances when prices have declined, and the benefit of an underwritten outcome. Uber, for example, priced its IPO at $45 but as it began to trade it dropped to a price of $36.

There have been too few direct listings to generalize how they may be done, and the rules are still evolving. Nevertheless, it is still instructive to understand what Spotify proved possible. Advised by three investment banks, the company

- drafted and filed for approval by the SEC an offering prospectus that defined how it and its shares could be described to potential investor in a form that both satisfied the law and matched investor interests. Spotify registered 55.7 million of its 117.1 million shares outstanding. Of the registered shares, it explained "Unlike an initial public offering, the resale by the Registered Shareholders is not being underwritten by any investment bank. The Registered Shareholders may, or may not, elect to sell their ordinary shares covered by this prospectus, as and to the extent they may determine."[55]
- did *not* indicate in the prospectus a price range in which shares might initially be offered to the public but did disclose prices at which shares unregistered shares had recently traded in secondary market
- arranged an on-line investor day presentation open to any interested investor,
- did *not* delegate to the investment banks the job of building a book of potential orders,
- did *not* sell at a price negotiated with a lead bank on the behalf of a syndicate a block of initial public offering shares.
- did *not* seek to allocate shares for sale to particular investors
- as described in Spotify's registration statement the price at which the directly listed shares would trade depended on a matching of buy and sell orders on the NYSE as facilitated by a designated market maker (an expert human) with the initial advice of Morgan Stanley acting as an expert and compensated by the company.

  > "The DMM [designated market maker] acting pursuant to its obligations under the rules of the NYSE, is responsible for facilitating an orderly market for our ordinary shares. Based on information provided by the NYSE, the opening public price of our ordinary shares on the NYSE will be determined by buy and sell orders collected by the NYSE from various broker-dealers and will be set based on the DMM's determination of where buy orders can be matched with sell orders at a single price. On the NYSE, buy orders priced equal to or higher than the opening public price and sell orders priced lower than or equal to the opening public price will participate in that opening trade. In accordance with NYSE rules because there has not been a recent sustained history of trading in our ordinary shares in a private placement market prior to listing, the DMM will consult with Morgan Stanley & Co. LLC, as our financial advisor ("Morgan Stanley"), in order for the DMM to effect a fair and orderly opening of our ordinary shares on the NYSE, without coordination with us, consistent with the federal securities laws in connection with our direct listing. Pursuant to such NYSE rules and based upon information known to it at

[55] Amendment No. 3 to Form F-1 of Spotify Technology S.A. March 23, 2018. Cover page.

> that time, Morgan Stanley is expected to provide input to the DMM regarding Morgan Stanley's understanding of the ownership of our outstanding ordinary shares and pre-listing selling and buying interest in our ordinary shares that it becomes aware of from potential investors and holders of our ordinary shares, in each case, without coordination with us.
>
> Similar to how a security being offered in an underwritten initial public offering would open on the first day of trading, before the opening public price of our ordinary shares is determined, the DMM may publish one or more pre-opening indications, which provides the market with a price range of where the DMM anticipates the opening public price will be, based on the buy and sell orders entered on the NYSE. The pre-opening indications will be available on the consolidated tape and NYSE market data feeds. As part of this opening process, the DMM will continue to update the pre-opening indication until the buy and sell orders reach equilibrium and can be priced by offsetting one another to determine the opening public price of our ordinary shares."[56]

Spotify's shares opened trading at $165.90 per share and closed the day at $149.01.

Total fees paid by the company to its financial advisors were $35 million, roughly the full underwriting discount that would have been paid on an offering of $500 million of primary shares. For the advisors, however, their participation in the direct listing was more profitable because they did not have to share any of the fee with an underwriting syndicate or for sales commissions and they bore no underwriting risk.

In August 2020 the SEC approved a NYSE proposal that will enable direct listings to include primary shares.[57]

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[56] Spotify F-1 2018. p. 185.

[57] https://www.sec.gov/rules/sro/nyse/2020/34-89684.pdf. Pursuant to the change, it will be permissible for an issuer to sell shares in a direct listing (an Issuer Direct Offering Order or IDO Order) provided, among other restrictions, the limit price of the IDO Order must be equal to the lowest price of the price range established by the issuer in its effective registration statement (the price range is defined as the "Primary Direct Floor Listing Auction Price Range"); the IDO Order must be for the quantity of shares offered by the issuer, as disclosed in the prospectus in the effective registration statement; an IDO Order may not be cancelled or modified; and an IDO Order must be executed in full in the Direct Listing Auction.

5.4.4 Special Purpose Acquisition Companies (SPACs)

SPACS are corporations established and capitalized to fund the acquisition, typically within 18-24 months (the commitment period) and subject to shareholder approval, of a single target that the SPAC sponsors undertake to find after the SPAC is funded. SPAC interests are commonly sold as public offerings. While they have periodically served as lucrative short-term exit vehicles, they have proven to be poor paths for long-term holders.

For a recent time, however, they proliferated as easy and lucrative products for underwriters to sell. They generated IPO-scale underwriting fees, were capitalized by their founders to fund their initial operations during the target acquisition phase, and – critically – provided investors an option to (i) approve targets selected by the SPAC founders or (ii) require the redemption of their interests with accrued interest.

During the 20 year period 2003-2022, an average of 68 SPACs were offered per year -- 22% of the number of IPOs offered.[58] Fueled by low interest rates (idling money in a SPAC involved little opportunity cost), public demand for access to private equity-like opportunities, and celebrity sponsorship, the SPAC market underwent a dramatic transformation in 2020-2021. Annual SPAC formations surged from 59 in 2019 to 248 in 2020. They peaked at 613 in 2021 raising approximately $162 billion and representing over 60% of all IPOs that year.[59]

In 2022, however, pricked by rising interest rates, poor post-merger performance of the 2019-2021 vintage SPACS, perceived disclosure abuses, and closer SEC scrutiny of their promotion, the bubble burst. SPAC formations fell to 86, and in 2023 to 21. Measured 3 years after their so-called "de-SPACing" the average 3 year SPAC return during the 10 year period 2013-2022 was -35%.[60] Negative votes and redemptions soared.[61]

In July 2024 the SEC implemented new SPAC disclosure requirements to address a range of issues that arose during the prior 3 years addressing potential dilution (including shareholder redemptions), SPAC sponsor compensation, underwriting fees, warrants, convertible securities, and PIPE financings. The rules also align required disclosures and legal liabilities in de-SPAC transactions more closely with traditional IPOs, including making target companies co-registrants on registration statements.

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[58] Data compiled by Jay R. Ritter. University of Florida. https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf

[59] See Jay R. Ritter, "Initial Public Offerings: Updated Statistics," University of Florida, Warrington College of Business, last modified January 5, 2024, https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf. And Michael Klausner, Michael Ohlrogge, and Emily Ruan, "A Sober Look at SPACs," *Yale Journal on Regulation 39*, no. 1 (2022): 228-329.

[60] Data compiled by Jay R. Ritter. University of Florida. https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf reported in https://www.fool.com/research/spac-statistics-ipos/

[61] See, for example, Michael Klausner and Michael Ohlrogge, "A Sober Look at SPACs," Stanford Law and Economics Olin Working Paper No. 559 (November 2020, revised July 2021), https://ssrn.com/abstract=3720919.

I suggest you go online to check recent SPAC issuance volumes, performance, and issues.

5.4.5 Post-IPO follow on sales

A common provision of most minority private equity investments are registration rights (discussed in Book 2) which define how sponsors can cause a company, once it is public, to register their shares for sales in follow-on offerings and open-market block sales and, sometimes, in the first place, to cause a company to go public.

To better enable sales of their interests after the expiration of lockups through open-market and follow-on underwritten offerings, experienced sponsors will prioritize the establishment through an IPO of a robust aftermarket and share appreciation trajectory above maximizing an IPO share price.

5.4.6 Sales of unregistered shares

Section 4(a) (1 ½) sales and Rule 144 permit sales by the owners of restricted (unregistered) securities. These should not be confused with exemptions, such as Section 4(a)(2) mentioned previously, that enable companies to issue unregistered shares.

Section 4(a)(1½) sales are transactions dependent on case law pertaining to Section 4(a)(1). That section exempts sales that involve (unregistered) securities sold to sophisticated investors. These would include sales of large minority interest positions by sponsors to accredited third parties. Accredited investors are an SEC defined category meant to capture, basically, financially sophisticated, wealthy investors.

Rule 144 permits affiliates of issuers, such as private equity funds with substantial ownership or influence over an issuer, to sell their holdings as unregistered securities so long as: they have been held for 6 months, if the issuer is an SEC registrant, or a year, if it is not; there is adequate information (as defined by the SEC) describing the issuer available to buyers; the sale is handled as an ordinary brokerage transaction and is reported to the SEC; and, importantly, the sale is limited in any 3 month period to 1% of the shares outstanding in a class or, if the shares are publicly traded, the greater of 1% of a class or 1% of the average weekly trading volume on an exchange during the four weeks prior to notice of the 144 sale.[62] Non-affiliates who have held their interests for at least a year may sell free of these restrictions.

5.4.7 Distributions-in-kind (DIKs)

Distributions-in-kind are direct distributions to limited partners of the holdings of a fund. Most private equity limited partnership agreements now require general partners to use their best efforts not to

[62] https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html

make DIKs but, rather, to convert portfolio assets to cash, to make distributions in cash, and to calculate carried interests based on those distributions.

Prior to 2000, sponsors commonly made DIKs immediately after IPOs. Sponsors deemed DIKs as realization events that triggered the payment to them of carried interests which were calculated based on the trading values at the time of distribution, even though underwriter lockups and the securities laws, generally restricted the sale by limited partners of the DIK shares they received. The DIKs thus transferred to limited partners the risks of price declines from IPO values during the restriction periods, the burden of determining if it was timely to sell shares after the restrictions lapsed, and, the costs of arranging sales. Following the tech crash of 2000, many DIK valuations declined substantially before they could be liquidated. A sufficient number of limited partners lost money then to change market practice. DIKs were made a last resort and their costs and risks became shared with sponsors.

5.4.8 Dividend Recapitalizations

These are not exits but they are a source of substantial distributable cash frequently pursued by sponsors when they find change of control multiples inadequate. They are discussed further in Chapter 10.

5.4.9 Wind-downs, liquidations, bankruptcy, and restructurings

These are not exits that sponsors hope to take but they sometimes must be. A material percentage of buyouts fail. Given their debt ratings at inception, this should not be surprising.

The focus in an investment assessment should be to identify probable sources of capital stack strain (e.g., operating and contextual issues) that can be mitigated and to build a capital stack that can withstand the ones that cannot be mitigated.

If the issue at hand is a deteriorating portfolio company situation, the focus of an assessment will be to identify the elements of the factor value chain and commercial system contributing to the problem and to rectify their deficiencies. This might involve, for example, making business model changes; reengineering operations; rationalizing assets; or renegotiating, refinancing, or augmenting the capital stack.

As discussed in Book 1, a substantial portion of distressed private equity backed companies successfully avoid bankruptcy by doggedly undertaking capital stack restructurings. Though more common in earlier stage companies, occasionally distressed later-stage mature ones can also be revived through product slate reprioritizations and new offerings. Not all problems are best resolved through cost cutting.

Of course, what are problems for some may be opportunities for others. Some private equity sponsors and engaged owners specialize in assessing opportunities among failing and bankrupt companies. Managing the intricacies of bankruptcy proceedings is a necessary skill for these investors.

5.5 Stakeholder Interests

Every private equity professional and organization has implicit and, often, explicit ethical standards, where ethics is broadly defined to include norms of social, interpersonal, commercial, and non-commercial behaviors that affect others. Given the concentration of economic and social power enjoyed by private equity funds, an excellent case can be made that sponsors' ethical standards rise to the level of responsibilities. If this perspective seems naïvely altruistic, an alternate, more self-interested one, would turn on the expectation that if such power is not exercised with respect for societal ethical expectations, it will eventually be curtailed. With either motive, then, the topic bears attention.

In some cases, the bounds of what is acceptable are clear. In others, they are not. In my view, unethical investments should only be pursued if a sponsor's mandate includes remediating such circumstances and is pursued with a clear commitment to redressing the defects. When ethical problems are found in an existing portfolio company, sponsors should act proactively and aggressively to correct them. In some cases, that is a legal requirement.

Figure 5-2
Illustrative PRI List of ESG Factors[63]

Environmental	Social	Governance
Air and water pollution	Customer satisfaction	Accounting standards
Biodiversity	Data privacy and protection	Anti-competitive behavior
Climate change	Diversity and equal opportunities	Audit committee structure
Deforestation	Employee attraction and retention	Board composition
Ecosystem services	Employee engagement	Bribery and corruption
Energy efficiency	Gov't and community relations	Business ethics
Hazardous materials	Human capital management	Compliance
Land degradation	Human rights	Executive remuneration
Resource depletion	Indigenous rights	Lobbying
Waste management	Labor standards	Political contributions
Water scarcity	Labor management relations	Risk management
	Marketing communications	Separation of chairman and CEO
	Product mis-selling	Stakeholder dialogue
	Product safety and liability	Succession planning
	Supply chain management	Whistleblower schemes

Most issues of ethical propriety, of course, are not clear cut. Middle ground cases arise and, different cultures may have different ethical expectations.[64] Consequently, since the inception of the

[63] Ibid. p. 31.

[64] Consider, for example, the differences that emerged concerning political norms between Singapore and its Western allies and financial counterparts in the 1990's. Representing what some referred to as the Singapore School of Thought, Singapore's Foreign Minister Wong Kan Seng explained at the United Nations in 1993, "Only those who have forgotten the pangs of hunger will think of consoling the hungry by telling them that they should be free before they can eat. Our

contemporary private equity period, organized efforts have accelerated to define appropriate global behaviors for sponsors and other professional investors regarding ESG (environmental, social, and governance) and PRI (Principles for Responsible Investment) issues.

Within the PRI initiative, there is a particular program for private equity to "provide a global collaborative platform for GPs and LPs to understand and develop good practices for ESG integration in PE investments."[65] In 2014 a committee organized to define PRI standards published a best practices report. The report includes a "non-exhaustive" list of ESG topics, summarized in Figure 5-2. Among the best practices recommended by the PRI is that a review of ESG considerations be made a part of private equity due diligence processes and that relevant ESG issues be included in transaction documentation and post-investment monitoring and governance. Again, this leaves great latitude to sponsors to select behaviors and decisions they believe are consistent to their own individual and social contexts.

The report also included an appendix listing thirteen non-governmental, governmental, and other consulting organizations prepared to provide specific advice on ESG issues. Again, this all leaves great latitude to sponsors to select behaviors and decisions they believe are consistent to their own individual and social contexts.

experience is that economic growth is the necessary foundation of any system that claims to advance human dignity and that order and stability are essential for development." [from: Cherian George. *Singapore: The Air-Conditioned Nation.* "Detour at History's End: Singapore's Asian Way." Landmark Books, 2000. p. 50.]

[65] Maarten Biermans, Ebel Kemeling, Willem van Lanschot (Spring Associates) and Fong Yee Chan and Natasha Buckley (PRI). *Integrating ESG in Private Equity: A Guide for General Partners*. United Nations Principles for Responsible Investment Initiative. 2014.

Chapter 6 Late-Stage Framework -- Part 3 of 3

6.1 Transaction Probability

Experienced financial sponsors are jealous of their time.[66] It is finite. They also value perceptions of their acquisition acumen and prowess. They will measure their probabilities of prevailing against identified strategic and other financial sponsors carefully. Sponsors and strategic buyers may have different costs of capital, capitalization preferences, and often perceptions of the changes in operating results they may be able to accomplish with a target. These costs and assessments are, of course, dynamic -- they change with markets. In periods of public market ebullience, for example, the cost of publicly traded capital for strategic buyers can be materially less than the leveraged cost of capital for financial sponsors.

So, regularly consider if your time is going to be well spent on a project. Pursuing the analysis and negotiation of an investment you will not be able to close is also almost always a waste of time. Illustrative questions you should consider in this regard include the following. Most of them can be evaluated before much effort is spent evaluating or pursuing a target, but some may emerge over time.

- Do you have access to the necessary resources, including time, to:
- Evaluate,
- Secure, and
- Fund the investment?
- What process will be used to select who will buy (in the case of a change of control) or fund (in the case of a financing) the target?
- Will it explicitly be an auction?
- Do you have more attractive alternative uses of time than to compete in that auction?
- Are there chances to collaborate legally with other bidders?
- What non-money considerations may affect the selection of a buyer or funder?
- How well does your fund match those criteria?

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[66] See, for example, Henry Sender and Jeevan Vasagar. "Private Equity Turns its Back on GLP's Landmark Asset Sale." *Financial Times*. June 22, 2017. "Private equity groups Blackstone, KKR, RRJ and TPG are among those who have looked at the GLP auction and have decided against making a comprehensive offer, according to eight people involved in the process. The Singapore-listed company has an enterprise value of $19bn. The reluctant bidders are concerned that an inside bid led by GLP's chief executive Ming Mei … will make other submission pointless, the people said. 'The process is a farce and the most unprofessional I have ever seen,' says a private equity executive. 'No fair play.' "

- Does your fund have any material opportunities to differentiate itself?
- Do others?
- Is the controlling shareholder disposed to collaborate with someone else or to compete by themselves?
- Are you being used as a stalking horse? If so, as a secondary consideration, if you are, will you be compensated through a termination or similar fee for preparing or winning a round of bidding but ultimately losing to a preferred competing offer?
- Are there predictably blocking anti-trust or regulatory constraints to consider?

This is not, however, just an initial assessment issue. It is an essential element in the design of transaction tactics. It should also be considered at each turn in the pursuit of a target as tactics are deployed, counterparties and competitors react, and circumstances change. Deal fever is a private equity affliction that buyers must be manage in themselves. Adept sellers will try to promote it among buyers – which brings us to price, terms, and process.

6.2 Price, Terms, Projected Returns, and Negotation Strategy

Price and terms appear late in this framework because they are best designed and assessed with the benefit of the information developed by the preceding framework elements. Though price is correctly categorized as an acquisition term, for this discussion I will separate it from the others. Price will refer to how much and what types of capital are placed at risk enroute and at closing. Terms will refer to how the capital placed at risk is contractually ensured (for better or worse) to deliver the value intended.

The purpose of this framework element is to enable a sponsor to anticipate

- at what price and on what terms, if any, they and a selling counterparty may be able to settle in a transaction negotiation;
- the probability weighted (and preference adjusted) rates or return, multiples of capital, and reputational outcomes each combination of price and terms are likely to yield;
- a negotiation strategy; and
- stopping points -- prices and terms that will warrant withdrawal.

6.2.1 Price

Price is quite obviously a critical determinant of returns. "Never," Warren Buffett admonished his partners,

> count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results.[67]

Pricing decisions are typically based on interdependent sets of information – some tactical, others, more strategic. They will typically include the following:

- The target's trading price history. Sellers will naturally anchor their expectations to recent highs. They will also be aware of the change of control premiums normally paid to unaffected trading prices (see below) and set another anchor with them relative to recent prices. If prices are especially depressed, they may simply consider it an inopportune time to contemplate a sale unless it is priced at a greater than normal premium.
- An analysis of the average cost bases of major holders. Shareholder lists will normally change significantly after an offer is rumored or made. At least some long-term holders generally seek to lock in some gains as arbitrageurs bid up target share prices toward their probability weighted assessments of a bid actually emerging, an offer closing, or one being topped. Nevertheless, it is still relevant to consider how an offer may be received by major holders by studying their cost bases.
- Ongoing analyses of the cost bases of arbitrageurs.
- Trading multiples for comparable companies, annotated to identify significant events relevant to placing current multiples in long-term context. This is a shorthand way to determine if a company is perceived more or less favorably by investors.
- Change of control multiples paid for comparable companies, annotated to identify significant events relevant to placing current market conditions in long-term context.
- Change of control premia to unaffected market prices paid for comparable companies annotated to identify significant events relevant to placing current market conditions in long-term context.
- Estimates by securities industry equity analysts of the long-term (and sometimes the breakup) value of a target.
- Estimates of a target's long-term strategic value developed by it on its own or by its investment banks. These are generally confidential documents. They may, however, be shared in the course of negotiations and can become public as part of required transaction-related SEC filings made after a transaction is announced but before it is closed. Lacking access to such

[67] Bill Gates. "What I learned from Warren Buffett." https://hbr.org/1996/01/what-i-learned-from-warren-buffett

information, buyers should try to reverse engineer how a seller and its representatives are likely to value a target so they can anticipate their expectations and the axes along which they may plan to negotiate terms and price. Some companies defer making such calculations or seeking such advice until they are confronted by an offer. Others feel it is appropriate to make and regularly update such intrinsic value estimates. They can have a material bearing on board member perceptions of takeover proposals.

- The identities, levels of interest, bidding capacities, and past pricing behaviors of potential competing strategic, financial, and capital markets bidders. This kind of competitive intelligence can be very important, especially in inefficient markets. One of the reasons sponsors hire investment banks to assist them is for the market and company specific information that they can provide. It is the business of investment banking coverage, transaction groups, and analysts to track and analyze transactions and trends, and to be in direct contact with and to understand the needs and behaviors of targets and other market participants, including other sponsors, strategic investors (industrial buyers), and the capital markets.

All this information can be critical as a basis for understanding how a target and competing bidders are likely to react to an offer and how to plan for the evolution of pricing offers, demands, and counteroffers over the course of what is, inevitably, a negotiation.

At the end of the day, however, what should matter to any buyer is not whether they get to buy a target – that usually means they simply offered to pay the highest price – but rather, whether they have bought it at a price they believe, on an informed basis, will earn a satisfactory return.

As they are bidding for a target, buyers can only estimate what those returns may be. The best tools they have to forecast them are probability weighted return calculations (e.g., internal rate of return and multiple of invested capital) based on well-constructed and thoughtfully weighted sets of scenarios, including value creating initiatives across as many factors as they believe they can achieve.

If, based on the most informed objective analysis a buyer can do, a price will not credibly support a rate of return in their best interests, they should not make an offer at that level. Bidding requires discipline and self-awareness. Sponsors and limited partners are rightly sensitive to suggestions that a fund has pursued an investment for any other reason, such as building or defending a franchise. Similarly, corporate executives will be sensitive to criticisms of their acquisition acumen and motivations.

Investment bankers are generally paid fees for transactions that close and virtually nothing for those that do not. Obviously, this can misalign their short-term interests with those of the clients who retain them to advise on target pricing and expose them to having their motives questioned. Bruce Wasserstein, a once prominent M&A banker, for example, was derisively nicknamed 'bid 'em up Bruce' by *Forbes* for his "brand of rough 'psychological bullying' to get his clientele of corporate empire

builders to pay whatever price was necessary for victory," including what was referred to as his 'Dare to be Great' speech.[68]

The story of the contested $25 billion 1989 acquisition by KKR of RJR Nabisco (at the time, the largest buyout ever) is rich with private equity lessons, including several that highlight the central place of the range pricing information in private equity transactions I just described. So, I will digress for a few paragraphs to describe relevant aspects of that transaction based largely on an article written by Bill Saporito of *Fortune* titled "HOW ROSS JOHNSON BLEW THE BUYOUT The untold story of how his own naivete, a disastrously flawed strategy, and Wall Street's towering egos combined to doom a CEO's bid for glory in the biggest deal of all time."[69]

> In October 1988, Ross Johnson (RJR's CEO) broached the idea to his board that he might wish to undertake a leveraged buyout of RJR.
>
> The ensuing dinner discussion with the board evolved more quickly than Johnson and his advisors at the investment bank Shearson -- Peter Cohen (Shearson's CEO) and J. Tomlinson Hill (a senior Shearson M&A banker) -- had anticipated. The directors wanted to know what kind of price Johnson was considering. Charles Hugel, then CEO of Combustion Engineering and Non-Executive Chairman of RJR, responded to Johnson "We want to make sure that the number you were thinking about was not frivolous." "Define 'frivolous' for me," Johnson reportedly asked. Hugel told Johnson that anything less than the highest price at which RJR had ever traded -- $71 a share -- was unacceptable.
>
> Based on Shearson's analysis of RJR and their awareness of typical change of control premia, Cohen and Hill had advised Johnson to tell the RJR board he "was prepared to put up a minimum of $75 a share, but that he couldn't say exactly what price they would offer." This was, Cohen later explained, "a logical place to start." It was a 35% premium to the market (a standard rule of thumb M&A premium at the time) and, as Hugel had insisted, a premium to the highest price at which the stock had traded. "All the criteria," Peter Atkins of Skadden Arps, the board's legal counsel, later said, "indicated it was a responsible price."
>
> But, as Saporito wrote, it was nevertheless "remarkably cheap in light of the mushrooming amounts commanded by food companies in the fall of 1988" – a reference to prices being paid in change of control transactions for the comparable portion of RJR Nabisco.
>
> $75 was also materially less than valuation analyses in RJR's own corporate files which reached $100 per share. "This low-ball bid made Johnson and his management group seem a bunch

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[68] Robert Lenzer. "Bid em Up Bruce: A Winner, Hands Down." *Forbes.* October 14, 2009.

[69] Bill Saporito. "HOW ROSS JOHNSON BLEW THE BUYOUT The untold story of how his own naivete, a disastrously flawed strategy, and Wall Street's towering egos combined to doom a CEO's bid for glory in the biggest deal of all time." *Fortune Magazine.* April 24, 1989.

of quick-buck artists trying to grab the company cheap," Saporito reported. It angered RJR's directors and, once more widely known, quickly attracted competing interest from, among others, KKR.

The board put RJR up for sale in a process that eventually led to an agreement with KKR valued at $109 per share.

Underscoring the importance and perceived interdependencies for his form of discipline, pricing, information, motivations, and scenarios, a few hours after prevailing in KKR's final bid for RJR, Henry Kravis explained in a conversation with Colin Leinster of *Fortune*

> KKR is an incredibly disciplined place, and we focus very narrowly on what we're doing, how to play the transaction, and how to structure it best …
>
> I think Ross Johnson ((RJR's chief executive)) made a number of mistakes. When he made his first offer, a management buyout at $75 a share, my first reaction was to think that RJR was in play -- and at a price substantially lower than its real value …
>
> The most important thing is to have as perfect knowledge as you can of the transaction, and if you read enough, you're going to pick up something somewhere …
>
> It was reported during this transaction that I was upset when others came in after RJR and that I'd said deals this big are KKR's franchise. I never said that. We don't make decisions because we think we have a franchise, and it's an insult to say we do …
>
> It's important to us to know that we could perform well in a downturn. All the numbers we ran, all the analyses we did, had recession scenarios. We took management's projections -- we always haircut management's projections -- and then ran our own numbers based on inflation scenarios, with higher interest rates and a downturn in the economy. In any event, KKR is going into a company that will have $7 billion in equity and $23 billion of debt. That's a debt-to-equity ratio of 3 to 1, really low. We've rarely bought a company with a ratio that low, and I can't name many that have. It's usually 10 or 12 to 1. Others have gone as high as 25 to 1. This is because we want to make sure that it is a safe transaction.[70]

[70] Colin Leinster and Cynthia Hutton. "Greed Really Turns Me Off." *Fortune.* June 2, 1989. https://archive.fortune.com/magazines/fortune/fortune_archive/1989/01/02/71449/index.htm

That was Kravis' perception, or at least what he wanted readers of *Fortune* to believe it had been.

In the end, of course, the price KKR paid proved too high.

Summarizing how the investment worked out roughly 15 years later, in 2004, Floyd Norris wrote for the *International Herald Tribune*, that notwithstanding KKR's careful scenario planning,

> The greatest leveraged buyout ever is ending, not with a bang but with a whimper of loss … Kohlberg Kravis's equity investment of $3.5 billion came from its 1987 fund, which raised a total of $5.6 billion from institutional investors. That fund will wind up losing $730 million on the RJR Nabisco and Borden investments [for which a portion of RJR was exchanged] …[71]

6.2.2 Price and Term Trade-offs

To complete a private equity transaction, buyers and sellers must discover between them an equilibrium combination of price and terms. Price and terms are interdependent and, in most private equity transactions, bespoke. Buyers work to have the probability adjusted cost of risks that cannot be mitigated by the terms of an investment reflected in its price. Conversely, sellers will work to maximize price and to leave any uncertainties with a buyer.

Sponsors, of course, can be buyers as well as sellers and will adeptly assume negotiating postures that serve their interests at the time. To simplify the following discussion, I will refer to a change of control transaction in which the sponsor is a buyer and will purchase a target for cash. With little adjustment you should recognize the concepts are applicable where sponsors are sellers.

Figure 6-1 illustrates the problem buyers and sellers need to solve when designing combinations of prices and terms. This is a theoretical illustration. In actual practice, tradeoffs between price and other terms are not plotted this way. But do not let that blunt the point of the illustration, which is to unsettle the tendency of modelers (i) to ignore the relevance of terms to the definition of acceptable price and (ii) to anchor on single prices.

The X-axis of Figure 6-1 charts the price of a target.

The Y-axis plots the benefit of transaction terms to the sponsor (in this example, the buyer). The greater the Y-axis value, the more advantageous the terms are to the buyer.

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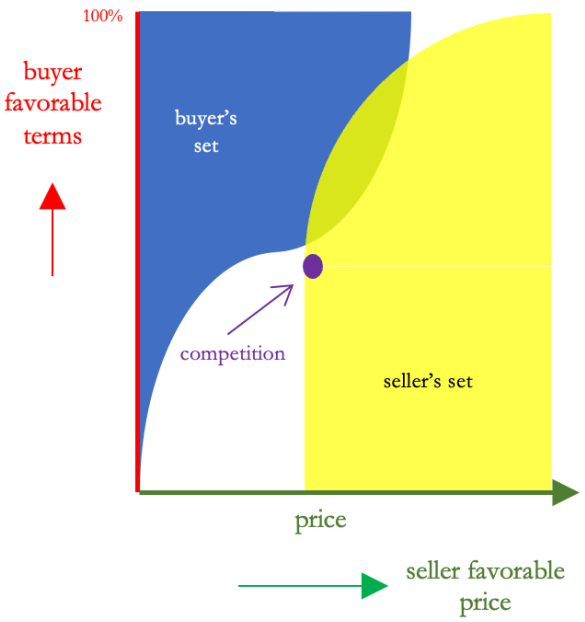
[71] Floyd Norris. titled "Fund books loss on RJR after 15 years: A long chapter ends for KKR." *International Herald Tribune.* July 9, 2004.

The blue shape illustrates sets of prices and terms that satisfy the objectives of a buyer, and the yellow shape, sets acceptable to a seller. The purple dot represents the seller's best available combination of price and terms from among all the buyers competing with the sponsor.[72] All competing offers could be plotted as another colored domain but are not because they would just clutter the figure. What matters is the best competing alternative.

The lower edge of the blue buyer domain indicates that as the buyer can secure better terms, it is willing to pay more, but not beyond a maximum price. Prices above that are not expected to yield an adequate return on investment. The seller's solution is bounded on the low end by the buyer's competition and, above that price, along its upper edge, reflects the seller's willingness to accept more stringent buyer terms in exchange for higher prices.

Figure 6-1



The overlap at the center of the figure indicates a possible set of solutions that satisfy both the buyer and seller and exceed the price of the best competing alternative.

The shapes of the solution sets in Figure 6-1 are meant to emphasize that *ranges* of prices and terms may meet a buyer's and seller's needs. Note that there are two points of intersection at the edges of the blue and yellow domain, at which the buyer and seller could, theoretically, feel they had on the margin both satisfied their price and term objectives. As illustrated, both points also happen to offer a superior price to the seller than the best available competing offer.

The existence of such theoretical solution sets does not, of course, mean that the parties to a negotiation will reach an agreement in or outside of one of those zones. Bidding and negotiating strategies, tactics, and effective execution are essential to advance an opportunity beyond an assessment. Each party to a private equity negotiation must gauge their leverage to attain different combinations of price and terms. A transaction closing, if one can be reached, will depend on the

[72] For simplicity, in this example where a change of control is discussed, I refer to a seller, a buyer (the sponsor), and competing buyers. The same concepts are applicable in a minority investment. The names of the parties would just change to an offeror, an investor (the sponsor), and competing investors.

skills, behaviors, resources, and circumstances of the parties involved and may fall outside of the area of overlap to the detriment or benefit of a sponsor.

6.2.3 Non-Cash Consideration

The form of consideration in any change of control is a key consideration. The focus to this point on cash as a form of consideration in changes of control has been both a reflection of how most buyouts are structured and a simplifying limitation.

Other forms of change of control consideration frequently used include common shares and common share equivalents (such as convertible preferred stock or debt); fixed income instruments; and more esoteric arrangements such as earn outs, contingent value rights (fixed payments tied to uncertain future events), and royalty interests. There are compelling reasons why they are offered and accepted under different circumstances. I will highlight several here and develop them further in later chapters.[73]

Sensibly, seller preferences influence how offers are structured. Their priorities are typically:

- the total value of what they are to receive,
- the certainty of that value – in terms of both volatility and the liquidity,
- the concentration of risk and limitations on diversification that different forms of consideration may impose; and
- how it will be taxed. For example, capital gains can be deferred on some transactions structured largely with common stock; whereas, cash consideration will trigger tax liabilities on receipt (see Section 368 discussion below).

Buyers typically try to balance at least the following considerations. Read the list twice and consider how each of the nine is likely to relate to the others.

- Seller Preferences.

[73] For readers with an interest in transactions of the past, you should be aware that until 2001, goodwill amortization did not apply to companies where as little as 5% of the equity consideration consisted of equity. This disadvantaged all cash purchases. So, some sponsors anticipating exits based on valuations determined as a function of net income (as in initial public offerings priced as a function of p/e ratios) eliminated goodwill deductions from net income through the preservation of 5% independent minority interests in their portfolio companies. In 2001, however, GAAP purchase accounting standards for the mandatory forty-year amortization of goodwill were amended (Statements of Financial Accounting Standards 141 and 142) to require the write down of a purchase price premium only when its value is determined to be diminished. See the following paper produced by the accounting firm Deloitte for a detailed discussion of FAS 141 and 142: http://www.iasplus.com/en/binary/dttpubs/0705applyingfas141and142.pdf

- Competition.

  For example, the competitive pressure in most sale processes enables sellers to require bidders to assume the risks of raising the portions any value they hope to fund with debt. Fixed income instruments are rarely a part of the consideration in acquisitions of public companies. In sales of smaller private companies, however, bargaining positions are sometimes reversed and buyers can prevail in using debt recourse to the combined company or only the target (seller paper) as a form of consideration.

- Total Consideration Achieved.

  Buyers with costs of equity above their costs of borrowing will first utilize prudently available debt capacity to fund acquisitions. However, acquisition multiples of cash flow in many industries and for many rapidly growing companies greatly exceed the multiples of combined cash flows they can borrow. To enhance their purchase capacity, then, buyers will use equity as acquisition currency (to the point of tolerable earnings and control dilution, as noted below). Buyers with very high valuation multiples, and thus very low costs of equity capital, may offer equity alone. At the limit, buyers may also seek to enhance the value of their offers by including more esoteric consideration such as royalty interests or contingent value rights – instruments that convey to sellers a share of future, often somewhat uncertain, target upside.

- Dilution of Control.

  Sponsors co-exist in very large late-stage buyouts that exceed their individual capacities to invest and, very commonly, co-invest in syndicated financings of early and growth-stage companies. But, in manageably sized late-stage investments, will generally prefer not to share control with others. It can limit their flexibility and create fiduciary obligations to minority owners that are burdensome to administer. Thus, they will usually try not to use equity as a form of consideration – but, to prove the rule, see the discussion of partial stub exceptions.

- Dilution of Ownership.

  Equity issued by a buyer at a price that corresponds with a multiple of earnings less than the multiple paid for a target will reduce the buyer's pro forma earnings per share. Unless the buyer's multiple increases (is rerated) for some reason, its share price should therefore decline pro-forma for the acquisition. Thus, buyers, especially public strategic buyers, will moderate their use of equity as a form of acquisition consideration to minimize earnings per share dilution. Some owners are even more sensitive to dilution of another form. They prefer to avoid any reductions in their percentage ownership of their companies from equity issuances to third parties – regardless of the price at which it may be issued. This is more common in privately held companies, it is usually a matter of control, as explained above, and of economics. Having built a valuable concentrated holding with which they are familiar, such owners simply want to control whatever future compounded value they can generate.

- Regulatory Oversight.

  For private and non-US investors, issuing securities, such as common stock and common stock equivalents, that require SEC registration entails a major investment of time and effort and creates significant continuing obligations and liabilities. It will also likely prolong time to closing. For strategic investors that are already SEC registrants the incremental costs will be comparatively small but, updating a registration statement for them can still prolong closing schedules.

- Shareholder Approvals.

  If more than the authorized number of unissued shares of any buyer, or 20% of the outstanding common shares of a public company buyer, are to be issued in an acquisition, the approval of the shareholders of the buyer will have to be obtained to increase the authorized shares outstanding or to exceed the 20% threshold respectively. If a company is sponsor-funded, it will likely also need sponsor approval for any increase in authorized shares or acquisitions. The proxy solicitation processes for obtaining such approvals can also cause delays and will add another degree of risk for a seller to assess in selecting a buyer from among competing bids. If the issuer is public, they will also involve the costs, complications, and liabilities of SEC proxy filings and compliance with related regulations.

- Perceptions of Risk.

  It is common for sellers and buyers to assess the likelihoods and economic impacts of future uncertain events differently and thus to value the companies that confront them differently. Sometimes this will create irreconcilable differences. Sometimes, they lend themselves to resolution with forms of contingent value payments. However, the complexity of structuring such obligations, including providing for their liquidity and managing how they will be valued by third-party investors, will often limit their use.

- Taxes.

  Acquisition structures that convey tax benefits to sellers often create tax costs for buyers, and vice versa. Though these are usually secondary concerns, their impact can still be significant and complicated to manage. If tax deferral is a selling shareholder priority, prospective buyers may compete to satisfy this objective by structuring acquisition proposals to include equity consideration. This is clearly a benefit that conventional leveraged buyout structures, which pay only cash consideration, cannot provide.

Again, the transaction engineering used to address these topics, such as taxes, are developed further in later chapters. For now, focus on the issues and do not worry about the mechanics.

6.2.4 Has-Gets Tables

I will take a moment here to introduce a tool commonly used by investment bankers, the boards they advise, and special situations investors in discussions of price. Called a Has-Gets table, it summarizes what the buyers and sellers "have" per share before a combination and what they each will "get" per share as a result. Has-Gets tables are a quick way to evaluate a proposed transaction structure's impact on seller and buyer values per share and the buyer's creditworthiness. As tools for generating informed first impressions, Has-Gets can go a long way to putting opportunities in useful perspective. [74] To build Has-Gets tables you must understand the major modeling issues involved in multi-year projections but deal with them in a more abbreviated way. You will find references to Has-Gets tables on-line and in some SEC merger filings.

Value per share of the buyer is calculated in Has-Gets tables based on a measure of pro forma buyer performance per share (such as EPS) multiplied by a coefficient (a multiple like P/E) the buyer is likely to be accorded by investors pro forma for the transaction. Several multiples will often be tested to bracket what might occur: the buyer's P/E (trailing if trailing financials are used in the calculations, forward if forward projections are used); a blend of the buyer's and the seller's multiples weighted by some sensible measure, such as their relative contributions to EBITDA or enterprise value; and, if the acquisition is considered transformative, multiples attributed to pro forma comparable companies. These calculations may seem crude but in practice can yield remarkably close approximations of market behavior – perhaps because they are close to the ones arbitrageurs do as well. Facile modelers can easily automate the production of these different cases.

Figure 6-2 illustrates the basic set-up of a Has-Gets table and Figure 6-3 shows the calculations on which it is based. This is just an example – not a template -- built to show how various aspects of a transaction might be modeled.

I suggest you take an hour to build a Has-Gets table so you will have one available to you, understand its limitations, and, in the process of building it, come to understand the basic merger accounting issues by grappling with them – there is no better way, really. This is the kind of model that includes circular references so remember to turn on iterations in Preferences.

The calculations in this example are more detailed than many initial Has-Gets tables will need to be.

The example shown, distinguishes different outcomes (the Gets) based on the form of consideration paid and whether or not synergies are obtained. If the form of consideration were different (i.e., a

[74] There are many excellent on-line resources that teach how to build merger models and forecasts. Most focus on building multi-year projections of the three basic financial statements. Wall Street Prep, for example, provides students with a popular and reasonably comprehensive M&A model.

combination of shares and cash) or the types of synergies were different (i.e., they included working capital management improvements), the coding would have to change accordingly.

Significantly, the example shown assumes the buyer's multiple will not change pro-forma for the acquisition. This is a critical assumption. When you build your own Has-Gets table, do not make this assumption. Make a more sophisticated assumption – such as, a market capitalization weighted average of the buyer's and seller's unaffected pre-transaction multiples.

Figure 6-2
An Illustrative Has-Gets Table

	Seller		Buyer				
	Has	Gets	Has	Gets			
				Without Synergies		With Synergies	
				All Cash	All Shares	All Cash	All Shares
Share Price	$ 6.00	$ 8.00	$ 10.00	$ 11.03	$ 9.38	$ 12.28	$ 10.63
% Change		$ 0.33		$ 0.10	$ (0.06)	$ 0.23	$ 0.06
P/E Ratio	14.6	19.5	20.0	18.8	18.8	18.8	18.8
				pre mkt cap wgt av	pre mkt cap wgt av	pre mkt cap wgt av	pre mkt cap wgt av
Credit Ratios							
Debt / EBITDA	2.800		1.667	2.247	1.600	2.189	1.558
EBITDA / Interest	7.5		10.0	7.0	10.7	7.2	11.0
Debt / Capitalization	54.5%		33.3%	45.7%	30.0%	45.7%	30.0%
Debt (net of cash) / Capitalization	41.5%		16.7%	43.8%	20.2%	43.8%	20.2%
Book Values							
Debt	$ 4,200,000		$ 10,000,000	$ 16,851,630	$ 12,000,000	$ 16,851,630	$ 12,000,000
Preferred at Book Value	$ 10,000		$ -	$ -	$ -	$ -	$ -
Common Stock and Retained Earnings	$ 3,500,000		$ 20,000,000	$ 20,000,000	$ 28,000,000	$ 20,000,000	$ 28,000,000
Total	$ 7,710,000		$ 30,000,000	$ 36,851,630	$ 40,000,000	$ 36,851,630	$ 40,000,000
Market Value of Shares Outstanding	$ 6,000,000	$ 8,000,000	$ 20,000,000	$ 22,062,042	$ 26,752,554	$ 24,563,606	$ 29,254,117

Calculations are based on latest 12 month trailing figures as of QX 20XX and latest quarterly balance sheet as reported in SEC 10Q filings. Trading prices are as of XXX, which are assumed to be unaffected.

Figure 6-4 elaborates on how 6-2 is built. The blue cells indicate where inputs are required. The yellow cells are the ones coded to calculate a figure based on other cells. I have provided further explanations for the cells containing numbers keyed to the notes that follow.

Again, this stub is just an example of how to approach the underlying calculations. You may approach them differently and make the exercise more or less complicated. Do not simply slavishly try to replicate the example – think.

Has-Gets models generally require some tailoring to suit each transaction they are used to analyze. Since they are relatively small models, they can be tailored quickly.

The inputs in Has-Gets tables are typically sourced from web-based resources -- based either on the latest available balance sheets and trailing 12-month operating results or, the latest available balance sheets and roughly estimated one-year-forward projections. Be sure to indicate clearly on your final table what the sources of data are on which it is based.

Figure 6-3
Supporting Assumptions and Calculations for the Illustrative Has-Gets Table

		Seller		Buyer				
		Has	Gets	Has	Gets			
					Without Synergies		With Synergies	
Transaction Assumptions								
Pre-tax Interest Rate for New Debt	4.0%							
Portion of Goodwill Amortized	50.0%							
Goodwill Amortization Life	20							
Transaction Cost as % Seller Equity Value	1.000%							
Cost to Raise New Debt	0.875%							
Amortization Life of Transaction Cost	15							
Operating Assumptions								
Minimum Days Cash (Rev-EBITDA)/365		15		15				
Rate of Return on Cash				1%				
Tax Rate		50%		23%				
Synergies						$ 200,000	$ 200,000	
Balance Sheet Items								
Cash		$ 1,000,000		$ 5,000,000	$ 719,178	$ 3,830,000	$ 719,178	$ 3,830,000
Interest income lost					$ (26,404.11)	$ (10,850.00)	$ (26,404.11)	$ (10,850.00)
New Debt					$ 4,976,263	$ -	$ 4,976,263	$ -
Debt that will Roll Over		$ 2,000,000		$ 10,000,000	$ 12,000,000	$ 12,000,000	$ 12,000,000	$ 12,000,000
Debt that will be Refinanced		$ 2,000,000		assume 0	$ -	$ -	$ -	$ -
Interest Expense on Refinanced Debt	4.0%	$ 80,000						
Convertible Debt that will Convert		$ 200,000		assume 0	$ -	$ -	$ -	$ -
Interest Expense on Convertible Debt	5.0%	$ 10,000		$ -				
Total Debt		$ 4,200,000		$ 10,000,000	$ 16,976,263	$ 12,000,000	$ 16,976,263	$ 12,000,000
Preferred Stock that will Roll Over		$ -		$ -	$ -	$ -	$ -	$ -
Preferred Stock that will be Refinanced		$ 10,000		assume 0	$ -	$ -	$ -	$ -
Preferred Stock that will Convert		$ -		assume 0	$ -	$ -	$ -	$ -
Total Preferred Stock		$ 10,000		$ -	$ -	$ -	$ -	$ -
Common Stock and Retained Earnings		$ 3,500,000		$ 20,000,000	$ 20,000,000	$ 28,000,000	$ 20,000,000	$ 28,000,000
Total Equity Capital		$ 3,510,000		$ 20,000,000	$ 20,000,000	$ 28,000,000	$ 20,000,000	$ 28,000,000
Fully Diluted Shares Outstanding								
Pre-Transaction		1,000,000		2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
Issued as Consideration					0	809,162	0	713,005
Total					2,000,000	2,809,162	2,000,000	2,713,005
Income Statement								
Revenue		$ 5,000,000		$ 20,000,000	$ 25,000,000	$ 25,000,000	$ 25,000,000	$ 25,000,000
Synergies					$ -	$ -	$ 200,000	$ 200,000
EBITDA		$ 1,500,000		$ 6,000,000	$ 7,500,000	$ 7,500,000	$ 7,700,000	$ 7,700,000
Amortized asset value difference					$ 112,500	$ 112,500	$ 112,500	$ 112,500
Amortized transaction and debt issue costs					$ 8,236	$ 5,333	$ 8,236	$ 5,333
Interest		$ 200,000		$ 600,000	$ 882,646	$ 699,150	$ 882,646	$ 699,150
Pre-Tax Income		$ 800,000		$ 1,300,000	$ 1,896,617	$ 2,083,017	$ 2,096,617	$ 2,283,017
PTI Wghtd Tax Rate (no interest cap)					33%	33%	33%	33%
Net Income		$ 400,000		$ 1,000,000	$ 1,264,412	$ 1,388,678	$ 1,397,745	$ 1,522,011
Adjusted Net Income for FD EPS		$ 405,000		$ 1,000,000	$ 1,264,412	$ 1,388,678	$ 1,397,745	$ 1,522,011
FD EPS		$ 0.41		$ 0.50				
Calculated value based on inputs		$ 0.41		$ 0.50	$ 0.63	$ 0.49	$ 0.70	$ 0.56
Transaction Sources and Uses								
Uses								
Acquisition of Seller Shares					$ 8,000,000	$ 8,000,000	$ 8,000,000	$ 8,000,000
Debt Refinanced					$ 2,000,000	$ 2,000,000	$ 2,000,000	$ 2,000,000
Preferred Refinanced					$ 10,000	$ 10,000	$ 10,000	$ 10,000
Transaction Costs					$ 80,000	$ 80,000	$ 80,000	$ 80,000
Debt Issuance Costs					$ 43,542	$ -	$ 43,542	$ -
Total					$ 10,133,542	$ 10,090,000	$ 10,133,542	$ 10,090,000
Sources								
Excess Cash					$ 5,157,280	$ 2,090,000	$ 5,157,280	$ 2,090,000
New Debt					$ 4,976,263	$ -	$ 4,976,263	$ -
New Equity Issued						$ 8,000,000		$ 8,000,000
Total					$ 10,133,542	$ 10,090,000	$ 10,133,542	$ 10,090,000
Cash and New Debt Calculation								
Starting Cash					$ 6,000,000	$ 6,000,000	$ 6,000,000	$ 6,000,000
Minimum Cash Required					$ 719,178	$ 719,178	$ 719,178	$ 719,178
Starting Less Minimum					$ 5,280,822	$ 5,280,822	$ 5,280,822	$ 5,280,822
Transaction Costs					$ 80,000	$ 80,000	$ 80,000	$ 80,000
Debt Issuance Cost					$ 43,542	$ -	$ 43,542	$ -
Available Cash					$ 5,157,280	$ 5,200,822	$ 5,157,280	$ 5,200,822
Total Uses					$ 10,133,542	$ 10,090,000	$ 10,133,542	$ 10,090,000
Equity Issued					$ -	$ 8,000,000	$ -	$ 8,000,000
Remaining Cash Need					$ 10,133,542	$ 2,090,000	$ 10,133,542	$ 2,090,000
Cash Used					$ 5,157,280	$ 2,090,000	$ 5,157,280	$ 2,090,000
Remaining Need for New Debt					$ 4,976,263	$ -	$ 4,976,263	$ -
New Debt					$ 4,976,263	$ -	$ 4,976,263	$ -
Remaining Cash					$ 719,178	$ 3,830,000	$ 719,178	$ 3,830,000

Figure 5-4
Build Notes for the Illustrative Table

	A	B	C	D	E	F	G	H	I	J	K	L
7					Seller			Buyer				
8					Has	Gets		Has	Gets			
9									Without Synergies		With Synergies	
10									All Cash	All Shares	All Cash	All Shares
11												
12	Share Price				1	2		3	4			
13		% Change										
14												
15	P/E Ratio											
16												
17	Credit Ratios											
18		Debt / EBITDA										
19		EBITDA / Interest							5			
20		Debt / Capitalization										
21		Debt (net of cash) / Capitalization										
22												
23	Enterprise Value											
24		Debt										
25		Preferred at Book Value										
26		Common Stock and Retained Earnings										
27			Total									
28												
29	Transaction Assumptions											
30		Pre-tax Interest Rate for New Debt										
31		Portion of Goodwill Amortized		6								
32		Goodwill Amortization Life		7								
33		Transaction Cost as % Seller Equity Value										
34		Cost to Raise New Debt										
35		Amortization Life of Transaction Cost		8								
36												
37	Operating Assumptions											
38		Minimum Days Cash (Rev-EBITDA)/365			9							
39		Rate of Return on Cash						10				
40		Tax Rate			11							
41		Synergies									12	
42												
43	Balance Sheet Items											
44		Cash										
45			Interest income lost						13			
46												
47		New Debt										
48		Debt that will Roll Over										
49		Debt that will be Refinanced			14							
50			Interest Expense on Refinanced Debt									
51		Convertible Debt that will Convert										
52			Interest Expense on Convertible Debt									
53			Total Debt									
54												
55		Preferred Stock that will Roll Over										
56		Preferred Stock that will be Refinanced										
57		Preferred Stock that will Convert										
58			Total Preferred Stock									
59			Common Stock and Retained Earnings									
60			Total Equity Capital									
61												
62	Fully Diluted Shares Outstanding											
63		Pre-Transaction			15							
64		Issued as Consideration										
65		Total										
66												
67	Income Statement											
68		Revenue										
69			Synergies									
70		EBITDA										
71			Amortized asset value difference									
72			Amortized transaction and debt issue costs									
73		Interest										
74		Pre-Tax Income										
75			PTI Wghtd Tax Rate (no interest cap)									
76		Net Income										
77		Adjusted Net Income for FD EPS										
78												
79		FD EPS										
80			Calculated value based on inputs		16							
81												
82	Transaction Uses											
83		Acquisition of Seller Shares										
84		Debt Refinanced										
85		Preferred Refinanced										
86		Transaction Costs										
87		Debt Issuance Costs										
88			Total									
89												
90	Transaction Sources											
91		Excess Cash										
92		New Debt										
93		New Equity Issued										
94			Total									
95												
96	Cash and New Debt Calculation											
97		Starting Cash										
98		Minimum Required										
99		Starting Less Minimum										
100		Transaction Costs										
101		Debt Issuance Cost										
102		Available Cash										
103		Total Uses										
104		Equity Issued										
105		Remaining Cash Need										
106		Cash Used										
107		Remaining Need for New Debt										
108		New Debt										
109		Remaining Cash										

Notes

1	Studying the recent price history, this should be a price unaffected by Buyer's interest. It is the price to which an arbitrageur should expect the stock price to decline if no bid ensues.
2	This is a critical input. It is the price per share the Buyer intends to offer for the target.
3	This can be the Buyer's price before or after the announcement. The advantage of using a post-announcement price is that it will reflect the market's first impression (probability weighted for the transaction to occur) of the idea and thereby infer a price at which shares might be valued by Seller's holders.
4	The values in these cells are critical results for this exercise. They are calculated as the pro forma EPS (e.g. I80) multiplied by the relevant multiple (e.g. I15).
5	The values in these cells are the other critical results for this exercise. If the transaction structure modeled yields ratios that are achievable and prudent, the case may make sense to pursue. If not, the structure will need to change or the transaction abandoned.
6	Goodwill is a largely obsolete but still useful term meant to refer to the difference between the acquisition cost of target assets and their book value. This coefficient is a quick and dirty way to toggle what portion of this difference will impact the income statement.
7	Historically, good will was presumed amortized over 40 years. Now, based on their characteristics, different assets may be assigned different lives. If an asset's values is not impaired over time, its value does not need to be amortized at all.
8	Technically, transaction costs should be capitalized and amortized. There is a 15 year safe harbor rule for amortization. Since this table does not require a balance sheet, you need only calculate the annual cost for the income statement.
9	This is probably not a material number but as a matter of discipline, it is good for financial analysts to remember that companies do require cash to function. To the consternation of operating executives, too many acquisition models strip companies of all their cash. The way this example is structured it anticipates modeling minimum cash as a blended combination of the Buyer and Seller ratios.
10	Income earned in the past on cash used to fund the acquisition will be lost to the combined company's income.
11	This example is set up to use tax rates calculated off the actual results input below to produce a blended estimate of pro forma tax rates. Do check, however, to ensure that recent tax rates have not been anomalous. Estimating tax rates for combined companies can be difficult and require expert advice to do with precision. Note that this model does not include caps on deductible interest. If you like, feel free to add that sort of detail but recognize that the accuracy of such calculations may easily be eclipsed by the inaccuracy of other assumptions.
12	Buyers will often announce the dollar amount of synergies they hope to achieve in a combination. As the operation of a model such as this will show, such assertions are often essential to justify pursuing them. In that vein, this cell may also be coded or used as a plug to solve for a desired EPS and Buyer share price.
13	This is obviously not a balance sheet item, but it is a convenient place to keep track of lost interest income for use elsewhere.
14	As discussed previously, most debt will need to be redeemed and refinanced in a change of control.
15	If not all common equivalents will convert this will not be the correct figure to use. Most changes of control, however, are priced to put common equivalents in the money, however, so this is a convenient number to use. Note that most on-line references will report the number of fully diluted shares used in EPS calculations. This is a weighted average number for the period reported and thus not necessarily the same as the the number of shares that will be outstanding and have to be acquired. It is a good idea to check the target financial statement to see how far these figures differ.
16	This cell is included as a quality control check to expose large differences in assumed shares outstanding or reported EPS adjustments.
17	The formula used here is just illustrative. Use a common sense solution.

6.2.5 Negotiating Strategies and Tactics

Finally, after all the calculations have been made, it is important to recognize that price and terms in private equity change of control transactions are outcomes of complex processes, even in tightly controlled auctions. Bids (combinations of price and terms) and perceptions evolve. They rarely end where they begin.

Again, returning to the RJR transaction as a case where process clearly played an important part, it was, Bill Saporito wrote for *Fortune*

> A sometimes pathetic tale, it is full of insight about how business really works when good intentions struggle with pride, ambition, and a thousand other human frailties in the red-hot crucible of competition … The execution of the buyout strategy was as flawed as the assumptions that went into it … Conflict between the bidding groups left the buyers in disarray and the sellers with the whip hand. The dynamics of distrust sent the ultimate price spiraling ever higher -- in an auction where a single dollar per share added about $225 million to the final price. Ultimately there was barely a nickel to choose between the final bids, leaving a special committee of RJR directors ample discretion to pick a winner … Out of this tumultuous fray RJR Nabisco's stockholders emerged as the only unambiguous winners … In the end KKR bested its rival because the firm was more flexible in negotiating with the special committee than were its opponents. [75]

Anticipating how a bid will evolve. Competing effectively in an M&A transaction involves integrating many factors including, without limitation,

- often divergent opinions;
- uncertain forecasts;
- many parts of the law;
- differing levels of negotiating and technical expertise; diverse interpersonal and security market dynamics;
- game theory;
- public and government relations;
- and serendipity.

Buyers and sellers will each seek to position the prices and terms they offer, and their profiles, as advantageously to themselves as they can. As in most negotiations, it is important for a buyer to try to anticipate a seller's expectations and for a seller to anticipate a buyer's. Seller expectations are usually comparatively more complex. Depending on how an opportunity has developed, information concerning them may be readily available or not. What data is available will, in any event, be noisy.

[75] Saporito. 1989. Ibid

Buyers are well advised to be cynical. The more seemingly transparent a brokered process or adept a seller's manner is, the more theater (inaccurate guidance) is often actually involved.

The legal obligations and business norms that have come to shape these dynamics are discussed in the following chapters.

6.3 Work to do

The final step in an assessment involves two parts:

- Defining what additional work needs to be done and then
- Deciding with the benefit of all that has been learned, and a sense of what remains to be done, whether
    - to continue to develop the opportunity,
    - shelve it for further future consideration, or
    - terminate its consideration.

Most investment opportunities will not survive an initial sponsor assessment. That is fine. Some of the best decisions sponsors make involve conserving their resources and avoiding losses.

6.4 Conclusion

Overall, then, when using this late-stage assessment framework:

- Do your homework.
- Do not confuse a coherent, confidently delivered story with a well-supported one.
- Be very aware of what you have not been able to learn.
- Be conscious of the tendency to select data that conforms to your expectations.
- Measure expectations against objectively established norms.
- Consider multiple outcomes. Think probabilistically. Accept that not all uncertainties can be reduced to a numerical point estimate.
- Understand which risks are irreducible and must be tested and managed over time.
- Follow-up. Identifying an uncertainty does not resolve it. Consider what additional work needs to be done and how it can be staged efficiently and cost effectively.
- Do not be pessimistic, but do not get deal fever.
- Expect to say no. Do not pursue an opportunity unless you believe both that:
    - The thesis is compelling, well developed, can be attractively priced and effectively documented; and
    - You have a credible chance of making the investment.