

ULTIMATE GUIDE TO M&A

Case Study: Microsoft Acquires LinkedIn

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Introduction to mergers and acquisitions

Mergers and acquisitions (M&A) is an umbrella term that refers to the combination of two businesses. It gives buyers looking to achieve strategic goals an alternative to organic growth; It gives sellers an opportunity to cash out or to share in the risk and reward of a newly formed business.

When M&A is successful, it holds the promise of enhanced value to both the buyer and seller. For the buyer, it can:

1. Accelerate time to market with new products and channels
2. Remove competition (buying a competitor is called horizontal integration)
3. Achieve supply chain efficiencies (buying a supplier or customer is called vertical integration)

Meanwhile, the cost savings that might be achieved by the reduction of redundant jobs and infrastructure (called synergies) can be shared by both the buyer and seller: The anticipation of lower costs going forward allows the buyer to afford a higher purchase price.

When M&A is unsuccessful, it can destroy value and especially hurt the buyer (since the seller is already cashed out). Poor due diligence, mismanaged integration and overestimation of potential cost savings are common reasons why mergers and acquisitions can fail.

Why we wrote this guide

In our role as a financial training company, we spend a lot of time in our classes explaining how to build M&A models. The goal of this guide is to take a step back from complicated number crunching and shed light on how deals are negotiated, structured and consummated in the real world.

Using **Microsoft's acquisition of LinkedIn** as our primary case study (and a couple of others along the way), we will break down the various parts of an M&A deal. Along the way, look for "Deep Dive" links that point to more specific details of the M&A process.

We hope this proves to be a valuable resource that quickly gives you a real-world understanding of mergers and acquisitions without the need to comb through voluminous textbooks. Let's begin.

Microsoft acquires LinkedIn

Barring leaks to the media, the first time the world will hear about a merger is usually through a merger announcement press release issued jointly by both companies. This is how we learned of the LinkedIn acquisition on June 13, 2016

Microsoft Corp. (Nasdaq: MSFT) and LinkedIn Corporation (NYSE: LNKD) on Monday announced they have entered into a definitive agreement under which Microsoft will acquire LinkedIn for \$196 per share in an all-cash transaction valued at \$26.2 billion, inclusive of LinkedIn's net cash.

[Download Full Press Release](#)

Form of consideration (cash vs stock)

So LinkedIn shareholders will cash out. In this deal, each shareholder gets \$196 in cold hard cash. However, buyers can also pay with their own stock in addition to, or instead, of cash.

Deep Dive: Learn all about how issuing acquirer stock vs cash impacts deals – Page 23

Calculating the Premium

To see what kind of premium the \$196 per share represents, we need to look at LinkedIn's share price prior to the announcement. Below, we can see how LNKD shares traded in the days leading up to the sale as well as the huge spike in volume and share price on the announcement date:

General Chart News & Analysis Financials Technical Forum						
Overview Profile Historical Data Options						
LNKD Historical Data						
Time Frame: Daily Download Data 06/07/2016 - 06/16/2016						
Date	Price	Open	High	Low	Vol.	Change %
Jun 16, 2016	191.33	191.06	191.66	191.00	3.46M	0.02%
Jun 15, 2016	191.29	191.50	191.77	191.25	5.81M	-0.18%
Jun 14, 2016	191.63	192.28	192.44	191.50	10.90M	-0.30%
Jun 13, 2016	192.21	194.29	194.38	192.16	26.47M	46.64%
Jun 10, 2016	131.08	135.00	135.36	130.90	2.00M	-3.98%
Jun 09, 2016	136.52	136.26	138.89	135.51	2.78M	1.99%
Jun 08, 2016	133.85	134.08	134.57	132.76	936.36K	0.11%
Jun 07, 2016	133.70	136.00	136.12	133.52	986.61K	-1.47%

Source: Investing.com. (On the job, you'd use a [fee based financial data service](#) for historical prices).

The premium was 49.5%: Shares closed at \$131.08 per share the Friday before the Monday announcement. The \$196 represents a 49.5% purchase premium. Acquirers always have to pay more than the seller's trading price. Otherwise, why would the seller agree?

	A	B	C	D
1	Microsoft acquires LinkedIn			
2		<u>Share price</u>	<u>Premium</u>	
3	Offer price - 6/13/16	\$196.00	49.5%	$\leftarrow = B2/B3 - 1$
4	Unaffected price - 6/10/16	\$131.08		
5				

How did this premium compare to other deals? According to Bloomberg, the vast majority (83%) of global M&A deals in 2016 had premiums between 10-50%, putting LinkedIn in the very high end. As we'll see, a bidding war benefitted the lucky shareholders at LinkedIn (and Microsoft's \$196 price wasn't even the highest offer!).

Deep Dive: Learn all about Purchase Premiums in M&A Here – Page 27

Deal structure

Ok, back to the press release:

LinkedIn will retain its distinct brand, culture and independence. Jeff Weiner will remain CEO of LinkedIn, reporting to Satya Nadella, CEO of Microsoft. Reid Hoffman, chairman of the board, co-founder and controlling shareholder of LinkedIn, and Weiner both fully support this transaction. The transaction is expected to close this calendar year.

It looks like LinkedIn's CEO Jeff Weiner will stay on. Here are the two CEOs talking about the strategic rationale:



As is usually the case in a friendly deal (a deal in which the buyer and seller management teams jointly announce the deal, as opposed to a hostile takeover in which the buyer doesn't have the support of seller management), you'll get some language in the announcement like this:

The Board of Directors of the Company (LinkedIn) unanimously determined that the transactions contemplated by the Merger Agreement, including the Merger, are in the best interests of the Company and its stockholders and approved the Merger Agreement and the transactions contemplated thereby, and unanimously resolved to recommend that the Company's stockholders vote in favor of adoption of the Merger Agreement.

Interpretation: LinkedIn's board of directors approved the deal and recommend that all the shareholders vote in favor of it.

Shareholder approval

Target shareholder approval is required

For a decision as significant as a sale of an entire company, it isn't enough for management and board to simply approve the deal. It can only go through if more than 50% of a company's shareholders vote to approve it. (In some rare cases, a supermajority is required: [Learn more – Page 32.](#))

In LinkedIn's case, co-founder and chairman Reid Hoffman owned more than 50% of the shares. As we will see shortly, he committed to voting for the deal ahead of the announcement, so the vote was a foregone conclusion. That's not always the case. In hostile takeovers or in proxy fights, there's risk that shareholders will not vote to support a transaction.

Is buyer shareholder approval required?

For transactions in which the acquirer issues more than 20% of its own stock, acquirer shareholders may also be required to approve the acquisition. This is the case in the CVS/AETNA deal. Per CVS' announcement press release:

The transaction is expected to close in the second half of 2018. It is subject to approval by CVS Health and Aetna shareholders, regulatory approvals and other customary closing conditions.

Merger vs. tender offer

The type of deal described in the Microsoft-LinkedIn press release is a traditional merger and represents the most common deal structure: The target's management negotiates with the buyer's management and board. They agree to terms, a merger agreement is signed and the deal is announced.

A less common way to structure a deal is via a **tender offer**. Tender offers are most common in hostile transactions and involve a buyer bypassing target's management and board and going directly to the target's shareholders with an offer.

Deep Dive: Learn about tender offer vs mergers – Page 32

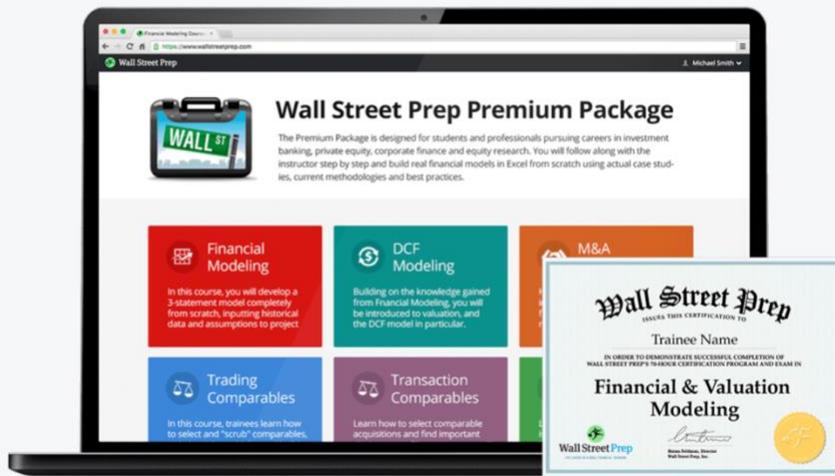
Asset sale vs stock sale

In the Microsoft-LinkedIn deal, Microsoft used its cash to acquire LinkedIn stock. We know this because the press release, merger agreement and proxy all describe how Microsoft is buying LinkedIn shares. The proxy lays out clearly that at closing, LinkedIn shareholders will receive \$196 for each of their shares, which will then be cancelled:

At the effective time of the merger, each outstanding share of Class A and Class B common stock (collectively referred to as "common stock") (other than shares held by (1) LinkedIn as treasury stock; (2) Microsoft, Merger Sub or their respective subsidiaries; and (3) LinkedIn stockholders who have properly and validly exercised and perfected their appraisal rights under Delaware law with respect to such shares) will be cancelled and automatically converted into the right to receive the per share merger consideration (which is \$196.00 per share, without interest thereon and subject to applicable withholding taxes).

However, there is another way Microsoft could have acquired LinkedIn: It could have acquired all LinkedIn's assets and assumed all liabilities. The decision to structure a deal as an acquisition of the target's assets vs an acquisition of target stock carries significant accounting, legal and tax issues. To learn more about the differences between these approaches, click on the "deep dive" link below.

Deep Dive: Asset sales vs stock sales – Page 37



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Deal documents

Merger documents

Up to now, we've been learning about the Microsoft LinkedIn deal solely from the detail provided in the announcement day press release. To understand a transaction beyond the headlines, we'll need to locate additional deal documents that the companies have provided.

We've included a guide about the contents of [key M&A documents here – Page 41](#) but let's summarize the key points below.

In a [traditional merger – Page 32](#) where the target is public (which is the case here), we rely on two documents:

1. The definitive agreement (merger agreement)
2. The merger proxy

The definitive agreement (merger agreement)

The press release announcing the deal is usually distributed to media outlets and is on both companies' websites. When a public company is acquired, it will immediately file to the SEC an 8-K that contains the press release. In addition, it will typically file the full [merger agreement](#) (usually found as an exhibit in the same 8-K that contained the announcement press release).

IN PRACTICE

The merger agreement is usually filed as an exhibit to the announcement press release 8-K or sometimes as a separate 8-K. Just search EDGAR for filings made on or around the announcement date.

The merger proxy

Because LinkedIn must get shareholder approval for this transaction, it must file a proxy statement with the SEC. When the vote concerns a merger, the proxy is called a **merger proxy** and is filed as a DEFM14A. If the proceeds include stock, the proxy is called a **merger prospectus**.

Both the merger agreement and proxy lay out in more detail the terms described in the press release. Specifically, the Microsoft-LinkedIn merger agreement details:

1. Conditions that would trigger the break-up fee – Page 45
2. Whether the seller can solicit other bids (go-shop” or no-shop – Page 48)
3. Conditions that would allow a buyer to walk away (material adverse effects – Page 52)
4. How shares will be converted to acquirer shares (when buyers pay with stock – Page 23)
5. What happens to LinkedIn option and restricted stock holders.

In addition, the proxy will go on to disclose a lot of details around deal negotiations, company projections, treatment of dilutive securities and other details that are more thorough and more clearly laid out than those in the legal jargon-heavy merger agreement.

IN PRACTICE

The merger proxy (or merger prospectus) is much easier to navigate than the merger agreement and is the primary data source used to understand key terms in the transactions.

Gap period between announcement date & close

The period between deal announcement (i.e. when the merger agreement is signed) and deal completion (i.e. when the two companies legally merge) can last anywhere from a few weeks to several months. There are several common deal terms negotiated between buyer and seller that specifically address what should happen in case of unforeseen circumstances during this period.

Perhaps the most well-known deal term that addresses risk during this "gap period" is the **breakup fee** the buyer will get if the seller backs out of the deal. In addition to the breakup fee there are several, often highly negotiated deal terms that M&A professionals can utilize in the deal process.

Breakup fee

The Microsoft-LinkedIn press release outlines a \$725 million breakup fee should LinkedIn back out of the deal for the following reasons:

Upon termination of the Merger Agreement under specified circumstances, the Company will be required to pay Parent a termination fee of \$725 million. Specifically, if the Merger Agreement is terminated by (1) Parent if the Company's Board of Directors withdraws its recommendation of the Merger; (2) Parent or the Company in connection with the Company accepting a superior proposal; or (3) Parent or the Company if the Company fails to obtain the necessary approval from the Company's stockholders, then the termination fee will be payable by the Company to Parent upon termination. The termination fee will also be payable in certain circumstances if the Merger Agreement is terminated and prior to such termination (but after the date of the Merger Agreement) an acquisition proposal is publicly announced or otherwise received by the Company and the Company consummates, or enters into a definitive agreement providing for, an acquisition transaction within one year of the termination.

In plain English, LinkedIn will pay Microsoft \$725 million if:

1. LinkedIn's board of directors change their minds
2. More than 50% of LinkedIn's shareholders don't approve the deal
3. LinkedIn chooses a competing bidder (called an "interloper")

There's good reason for buyers to insist on a breakup fee: The target board is legally obligated to maximize value for their shareholders. That's part of their fiduciary obligation. That means that if a better offer comes along (after a deal is announced but before it's completed), the board may be inclined to reverse its recommendation and support the new higher bid.

The breakup fee seeks to neutralize this and protect the buyer for the time, resources and cost already poured into the process.

Notice that buyer protection via a breakup fee is one-directional: No breakup fee was owed to LinkedIn should Microsoft walk away.

However, that doesn't mean Microsoft can just walk away unscathed. At deal announcement, the buyer and seller have both signed the merger agreement — a binding contract for the buyer. If the buyer walks away, the seller will sue.

Deep Dive: Learn more about the breakup fee – Page 45

Reverse termination fee

A seller also faces the risk of being left at the altar by the buyer, most notably the risk that the buyer will be unable to secure the financing required to get the deal done. As the name suggests, a **reverse termination fee** allows the seller to collect a fee should the buyer walk away from a deal.

To address this, the merger agreement (which we'll review shortly) might identify conditions that would lead to the seller collecting a reverse termination fee. There was no reverse termination fee in the Microsoft-LinkedIn deal. (This is more of an issue when the buyer is a private equity investor.)

Deep Dive: Learn more about reverse termination fees – Page 45

No-shop provisions

Recall how the press release disclosed that a breakup fee would take effect if LinkedIn ultimately consummates a deal with another buyer. The merger agreement has a section called "No Solicitation," commonly known as a no-shop, that prohibits LinkedIn from seeking other bids. Microsoft, like most acquirers, was weary of other suitors (particularly of Salesforce) and sought to protect itself. Ultimately the no-shop held, but as we shall see later, it did not prevent Salesforce from entering a higher **unsolicited** proposal bid for LinkedIn after the deal, which forced Microsoft to up the ante.

While most deals contain a no-shop, a small-but-growing number of deals contain a **go-shop**. The go-shop explicitly allows the seller to explore competing bids after the merger agreement. This is most common in go-private transactions in which the seller is a public company and the buyer is a private equity firm (as is the case in a traditional LBO).

Deep Dive: Learn more about no-shops and go-shops – Page 48

Material adverse change (MAC)

Another protection for the buyer is material adverse change (MAC), which gives the buyer recourse should the seller's business go completely off the rails prior to the deal closing. Microsoft included a MAC (as do virtually all buyers) in the merger agreement. The MAC gives the buyer the right to terminate the agreement if the target experiences a material adverse change to the business.

Deep Dive: Learn more about material adverse change – Page 52

Exchange ratios

While Microsoft paid for LinkedIn in cash, recall that sometimes companies will use their own stock as currency. When a buyer pays for a target with its own stock, there's another consideration: What if the acquirer share price drops between the announcement and closing date?

To address this, deals are usually structured with a **fixed exchange ratio** with the ratio fixed until the closing date. Alternatively, deals can be structured with a **floating exchange ratio**. Here, the ratio floats such that the target receives a fixed value no matter what happens to either acquirer or target shares.

Deep Dive: Fixed and floating exchange ratios – Page 55

Purchase price working capital adjustments

The amount of working capital that a seller has on the balance sheet at the announcement date may be materially different from the amount it has at closing. In an effort to protect itself from deterioration of the company's working capital position, buyers may structure an adjustment for working capital into the transaction that reflects changes between announcement and closing. For example, if at announcement a seller had net working capital of \$5 million but only \$4 million at closing, the purchase price would be adjusted down by \$1 million. (There was no working capital purchase price adjustment in the LinkedIn Microsoft deal.)

IN PRACTICE

Working capital price adjustments are exceedingly rare in public deals. However, they are a common feature in private transactions.

A real life example

When Lifecare Hospitals acquired several of Healthsouth's hospitals ([read more here](#)), it included a working capital purchase price adjustment. Per their merger agreement:

The purchase price to be paid by Buyers ... for the sale and purchase of the Purchased Assets as herein contemplated (the "Purchase Price") shall be an amount equal to (i) \$108,974,481, plus (or minus), (ii) an amount equal to the difference between the Final Net Working Capital and a deficit of \$954,698.71, minus (iii) the Indebtedness Adjustment Amount. The adjustments described in clauses (ii) and (iii) above collectively are referred to as the "Purchase Price Adjustments."

Contingent consideration and earn-outs

As you might guess, the most significant hurdle in M&A negotiation is an agreement on price. One way to bridge the valuation gap between what a target thinks it's worth and what a buyer is willing to pay is to structure contingent consideration (called an "earn-out").

When an earn-out is negotiated, the buyer will explicitly spell out milestones that would trigger additional consideration. Commonly, an earn-out payment will be contingent upon the target hitting EBITDA and revenue goals, or specific milestones such as a pharma target securing FDA approval of a drug.

Deep Dive: Learn more about earn-outs – Page 65

Treatment of Dilutive Securities: Stock Options and Restricted Stock

In a transaction, several things can happen to stock options and restricted stock. The merger proxy clearly lays out how option and restricted stock holders will be affected.

Treatment of unvested options and stock based awards (i.e. restricted stock)

The LinkedIn merger proxy lays out what happens to these securities — namely, unvested LinkedIn securities will convert to unvested Microsoft securities with the same terms:

... At the effective time of the merger, each company option and company stock-based award that is outstanding immediately prior to the effective time of the merger that is unvested will be assumed or substituted for by Microsoft and automatically converted into a corresponding equity award representing the right to acquire, on the same material terms and conditions, an adjusted number of shares of Microsoft common stock, subject to certain exceptions.

The merger agreement also specifies the conversion mechanism. Because Microsoft traded at around \$60 per share and LinkedIn shares were worth \$196 around the time of the acquisition, an unvested LinkedIn option would convert to ~3.3x MSFT options ($\$196/\60). (The \$60 is an approximation. As the merger proxy explains, the exact denominator will be determined as the volume weight 5-day average of MSFT stock prior to closing.) Converted options will also get a new exercise price – namely 3.3x the LNKD option exercise price:

The number of shares of Microsoft common stock subject to the new equity awards will be determined by a stock award exchange ratio based on the relative value of the per share merger consideration (\$196.00) and the volume weighted average price per share of Microsoft common stock for the five consecutive trading days ending with the complete trading day ending immediately prior to the closing date of the merger, with a corresponding adjustment to be made to the exercise prices of company options.

Treatment of vested options and stock based awards (i.e. restricted stock)

In this deal, all vested in-the-money options and all restricted stock is cashed out:

Any outstanding company options or company stock-based awards that are vested, will become vested in connection with the merger, or that are designated by Microsoft as cancelled awards instead will be cancelled and converted into the right to receive an amount in cash (less any amounts required to be deducted or withheld by law) determined by multiplying \$196.00 by the number of outstanding shares of LinkedIn common stock subject to the award (and in the case of company options, less applicable exercise prices).

In the case of vested options that are out of the money, the option holder gets nothing at all:

If the per share exercise price of any surrendered company option is equal to or greater than \$196.00, such surrendered company option will be cancelled as of the effective time of the merger for no payment and will have no further effect.

Accelerated vesting for executives

Unlike other LinkedIn employees who hold unvested options and restricted stock (their unvested securities will simply convert to unvested MSFT securities as detailed above), LNKD executives benefit from accelerated vesting. Specifically, executives will get accelerated vesting (50% or 100% based on their agreements) should they be terminated.

Also, each executive officer is eligible to receive immediate vesting of 100% or 50%, as applicable, of his or her outstanding company options or company stock-based awards under his or her offer letter (or change of control agreement) if, within 12 months following the merger, there is an involuntary termination of employment without cause, or a constructive termination as defined in the applicable offer letter (or change of control agreement). This is covered more fully below.

Key target shareholders

The merger proxy includes a list of all the entities and individuals that hold significant amounts of target shares.

Name of Beneficial Owner	Class A common stock		Class B common stock†		% of Total Voting Power#
	Shares	%	Shares	%	
5% Stockholders:					
Reid Hoffman and Michelle Yee, Trustees of the Reid Hoffman and Michelle Yee Living Trust dated October 27, 2009(1)	—	—	14,678,356	93.2	53.1
T. Rowe Price Associates, Inc.(2)	9,410,966	7.9	—	—	3.4
Prudential Financial, Inc.(3)	6,847,019	5.7	—	—	2.5
Sands Capital Management Inc.(4)	6,604,158	5.5	—	—	2.4
Jennison Associates LLC(5)	6,561,011	5.5	—	—	2.4
Capital World Investors(6)	4,513,883	3.8	—	—	1.6
Named Executive Officers and Directors:					
Jeffrey Weiner(7)	440,353	*	480,120	3.0	1.9
Steven Sordello(8)	105,104	*	129,095	*	*
Michael Callahan(9)	28,104	*	—	—	*
Michael Ganson(10)	36,457	*	107,667	*	*
J. Kevin Scott(11)	42,910	*	—	—	*
A. George "Skip" Battle(12)	17,634	*	5,554	*	*
Reid Hoffman(13)	—	—	14,678,356	93.2	53.1
Leslie Kilgore(14)	9,818	*	37,500	*	*
Stanley Meresman(15)	7,788	*	3,032	*	*
Michael Moritz(16)	671,620	*	—	—	*
David Sze(17)	30,938	*	—	—	*
All executive officers and directors as a group (12 persons)(18)	1,403,056	1.2	15,441,324	95.1	55.3

Source: LinkedIn Merger Proxy

Notice that LinkedIn has dual class shares (Class A and B) — a feature you'll see when insiders want to raise capital in an IPO while retaining voting control (for moments like this). This enabled LinkedIn co-founder and chairman Reid Hoffman (and other insiders) to retain voting control post-LinkedIn IPO. Google, Facebook, Groupon and Zynga are other companies with this type of arrangement.

Compensation for LinkedIn management that stay on or are terminated (“golden parachute”)

As the press release suggested, LinkedIn CEO Jeffrey Weiner will stay on. While no other executives had made a formal arrangement at the proxy date, most stayed on and negotiated contracts after the proxy. Page 68 of the proxy outlines Weiner's compensation for staying on. Page 71 also outlines which payments pertain to key executives that leave (though as of December 2017, they're all still at LinkedIn):

Golden Parachute Compensation

Name	LinkedIn Cash (\$)(1)	Microsoft Cash (\$)(2)	LinkedIn Equity (\$)(3)(4)	Microsoft Equity (\$)(5)	LinkedIn Perquisites / Benefits (\$)(6)	Microsoft Perquisites / Benefits (\$)(7)	Total LinkedIn Payments (\$)(8)	Total Microsoft Payments (\$)(9)
Jeffrey Weiner	2,500,000	3,022,292	17,468,055	18,530,555	24,076	49,258	19,992,131	21,602,105
Steven Sordello	1,100,000	—	10,804,400	—	24,076	—	11,928,476	—
Michael Callahan	1,000,000	—	8,353,520	—	24,076	—	9,377,596	—
Michael Ganson	1,100,000	—	5,737,656	—	24,076	—	6,861,732	—
J. Kevin Scott	1,200,000	—	7,353,925	—	24,076	—	8,578,001	—

Background of the merger

As we've seen, M&A transactions can be complex, with many legal, tax and accounting issues to sort out. But the decision to consummate a deal remains a very human negotiation process. While there have been great books written on the behind-the-scenes drama of major deals, information on how things played out for public deals is readily available in the surprisingly engaging **"Background of the Merger"** section of the merger proxy.



It's there that we learned the form of consideration (cash vs. stock) Reid Hoffman favored, the number of bidders involved, details on LinkedIn's management of [it's sell-side process – Page 68](#). The merger proxy even tells us how, after the deal with Microsoft was signed, one bidder came back in and offered significantly more!

Deep Dive: Read the behind-the-scenes events chronicled in the "Background of the Merger" section of the LinkedIn merger proxy – Page 74

Fairness opinion

As the "background of the merger" section of the proxy chronicles, on June 11, 2016, after management, Reid Hoffman, and the board-appointed Transaction Committee recommended the approval of the merger, Qatalyst Partners submitted its fairness opinion to LinkedIn's board:

The representatives of Qatalyst Partners then rendered Qatalyst Partners' oral opinion to the LinkedIn Board, subsequently confirmed by delivery of a written opinion dated June 11, 2016, that, as of June 11, 2016, and based upon and subject to the various assumptions, considerations, limitations and other matters set forth therein, the per share merger consideration to be received ... was fair from a financial point of view

The fairness opinion is included in LinkedIn's merger proxy. Simply put, it says Qatalyst believes the deal is fair.

The merger proxy not only includes the fairness opinion letter, but a summary of backup assumptions, inputs and specific valuation conclusions: Qatalyst's DCF and trading/transaction comps analyses yielded values for LinkedIn ranging from \$110.46 on the low end to \$257.96 on the high end. (Recall that the actual purchase price was \$196.00.) The fairness opinion is a controversial document since the financial advisor (in this case Qatalyst) is highly incentivized to align its opinion with management's.

Deep Dive: Learn all about the fairness opinion – Page 80

Synergies and accretion/dilution

When LinkedIn sought a higher offer from Microsoft in the later stages of negotiation, Microsoft performed a synergy analysis in order to ensure that the deal would not be dilutive. This was not a major hurdle for the Microsoft-LinkedIn deal, but for many strategic acquisitions, it is. In fact, it is so important that the acquirer will often identify synergies and quantify the accretion/dilution in EPS in the headline of the deal announcement press release, as we see in this deal announcement:

Hologic to Acquire Gen-Probe

Creates Leading Diagnostics Franchise Focused on Women's Health

Transaction Delivers Attractive Economics with Strong Growth and Margin Profile; \$0.20 Accretive to Hologic's Adjusted EPS in First Fiscal Year After Close

Companies to Host Conference Call at 8:15 AM ET Today

BEDFORD, Mass. and SAN DIEGO, April 30, 2012 /PRNewswire/ -- Hologic, Inc. (NASDAQ: HOLX) and Gen-Probe Incorporated (NASDAQ: GPRO) today announced that their Boards of Directors have unanimously approved a definitive agreement under which Hologic will acquire all of the outstanding shares of Gen-Probe for \$82.75 per share in cash, or a total enterprise value of approximately \$3.7 billion. The all-cash transaction is expected to be funded through available cash and additional financing of term loans and high yield securities. The transaction is expected to be completed in the second half of calendar 2012.

The transaction delivers a strong growth profile with attractive economics and is expected to be \$0.20 accretive to Hologic's adjusted earnings per share in the first fiscal year after close and significantly more accretive thereafter. Hologic also expects the transaction to accelerate top and bottom line growth rates. The combined company expects to realize approximately \$75 million in cost synergies within three years following the close of the transaction. In addition, the combined company expects to have strong free cash flows, which will be used primarily to reduce debt with the expectation to return to pre-transaction leverage levels within three years.

Appendices

How Buyers Pay in M&A: Cash vs Stock Acquisitions

How using acquirer stock as currency impacts the deal

In acquisitions, buyers usually pay the seller with cold, hard cash.

However, the buyer can also offer the seller acquirer stock as a form of consideration. According to Thomson Reuters, 33.3% of deals in the second half of 2016 used acquirer stock as a component of the consideration.

For example, when Microsoft and Salesforce were offering competing bids to acquire LinkedIn in 2016, both contemplated funding a portion of the deal with stock (“paper”). LinkedIn ultimately negotiated an all-cash deal with Microsoft in June 2016.

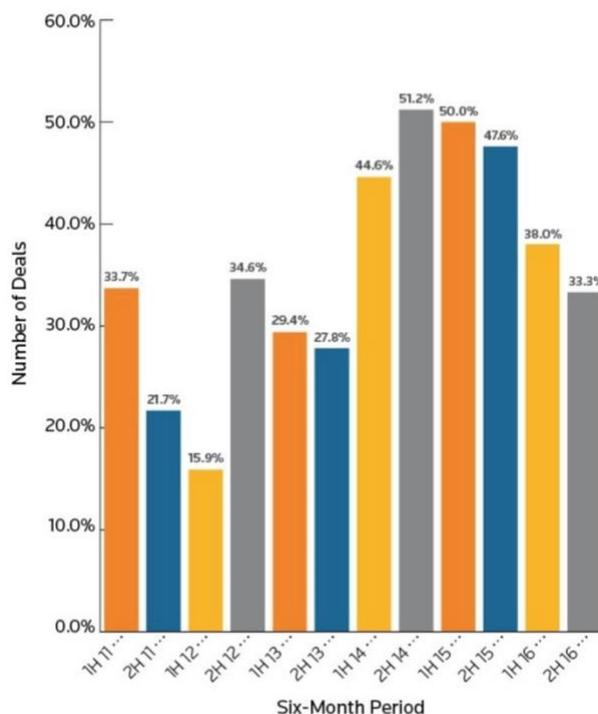
Why pay with acquirer stock?

For the acquirer, the main benefit of paying with stock is that it preserves cash. For buyers without a lot of cash on hand, paying with acquirer stock avoids the need to borrow in order to fund the deal.

For the seller, a stock deal makes it possible to share in the future growth of the business and enables the seller to potentially defer the payment of tax on gain associated with the sale.

Below we outline the potential motivations for paying with acquirer stock:

FIGURE D: PERCENTAGE OF DEALS WITH STOCK AS A COMPONENT OF CONSIDERATION



Source: Thomson Reuters

Risk and reward

In cash deals, the seller has cashed out. Barring some sort of “earn out,” what happens to the combined company – whether it achieves the synergies it hoped, whether it grows as expected, etc. — is no longer too relevant or important to the seller. In deals funded at least partially with stock, target shareholders do share in the risk and reward of the post-acquisition company. In addition, changes in acquirer stock-price fluctuations between deal announcement and close may materially impact the seller's total consideration (more on this below).

Control

In stock deals, sellers transition from full owners who exercise complete control over their business to minority owners of the combined entity. Decisions affecting the value of the business are now often in the hands of the acquirer.

Financing

Acquirers who pay with cash must either use their own cash balances or borrow money. Cash-rich companies like Microsoft, Google and Apple don't have to borrow to affect large deals, but most companies do require external financing. In this case, acquirers must consider the impact on their cost of capital, capital structure, credit ratios and credit ratings.

Tax

While tax issues can get tricky, the big-picture difference between cash and stock deals is that when a seller receives cash, this is immediately taxable (i.e. the seller must pay at least one level of tax on the gain). Meanwhile, if a portion of the deal is with acquirer stock, the seller can often defer paying tax. This is probably the largest tax issue to consider and as we'll see shortly, these implications play prominently in the deal negotiations. Of course, the decision to pay with cash vs. stock also carries other sometimes significant legal, tax, and accounting implications.

Let's take a look at a 2017 deal that will be partially funded with acquirer stock: CVS's acquisition of Aetna. Per the CVS merger announcement press release:

Aetna shareholders will receive \$145.00 per share in cash and 0.8378 CVS Health shares for each Aetna share.

[CVS/AETNA merger announcement press release](#)

Fixed exchange ratio structure adds to seller risk

In the CVS/AETNA deal consideration described above, notice that each AETNA shareholder receives 0.8378 CVS shares in addition to cash in exchange for one AETNA share. The 0.8378 is called the exchange ratio.

A key facet of stock deal negotiation is whether the exchange ratio will be fixed or floating. Press releases usually address this as well, and CVS's press release is no exception:

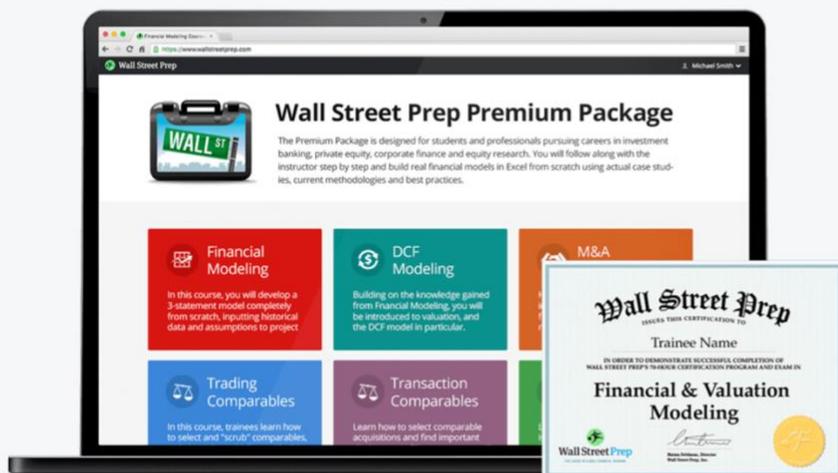
The transaction values Aetna at approximately \$207 per share or approximately \$69 billion [Based on (CVS)' 5-day Volume Weighted Average Price ending December 1, 2017 of \$74.21 per share... Upon closing of the transaction, Aetna shareholders will own approximately 22% of the combined company and CVS Health shareholders will own approximately 78%.

While more digging into the [merger agreement](#) is needed to confirm this, the press release language above essentially indicates that the deal was structured as a [fixed exchange ratio](#). This means that no matter what happens to the CVS share price between the announcement date and the closing date, the exchange ratio will stay at 0.8378. If you're an AETNA shareholder, the first thing you should be wondering when you hear this is "What happens if CVS share prices tank between now and closing?"

That's because the implication of the fixed exchange ratio structure is that the total deal value isn't actually defined until closing, and is dependent on CVS share price at closing. Note how the deal value of \$69 billion quoted above is described as "approximately" and is based on the CVS share price during the week leading up to the deal closing (which will be several months from the merger announcement). This structure isn't always the case — sometimes the exchange ratio floats to ensure a fixed transaction value.

Strategic vs. financial buyers

It should be noted that the cash vs. stock decision is only relevant to "strategic buyers." A "strategic buyer" refers to a company that operates in, or is looking to get into, the same industry as the target it seeks to acquire. "Financial buyers," on the other hand, refers to private equity investors ("sponsor backed" or "financial buyers") who typically pay with cash (which they finance by putting in their own capital and borrowing from banks).



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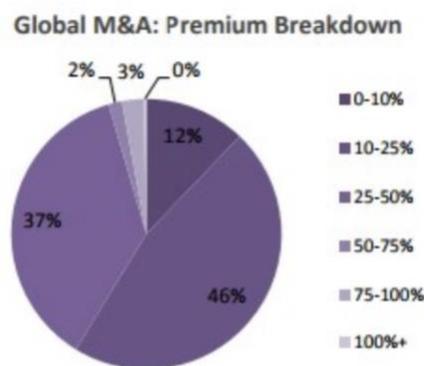
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Premiums Paid Analysis in M&A

A guide to understanding and calculating purchase premiums in M&A

A "**purchase premium**" in the context of mergers and acquisitions refers to the excess that an acquirer pays over the market trading value of the shares being acquired. "Premiums Paid Analysis" is the name of a common investment banking analysis that reviews comparable transactions and averages the premiums paid for those transactions. Looking at historical premiums when negotiating the acquisition of a public company is a key part of framing the purchase price range. Additionally, the selling company's management team will retain an investment bank to analyze historical premiums paid on comparable transactions to demonstrate to their shareholders that they have done their duty of maximizing value to shareholders.



Source: Bloomberg

Premiums range widely in M&A

The vast majority (83%) of global M&A deals in 2016 had premiums between 10-50%, according to Bloomberg. When Microsoft acquired LinkedIn on June 13, 2016, it paid \$196 per share, representing a 49.5% premium over LinkedIn's closing share price of \$131.08 per share the day prior to the deal announcement.

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Premiums tend to be higher in **strategic deals** (one company acquiring another company) as opposed to **financial deals** (a private equity firm acquiring a company). That's because a strategic acquirer often gains cost savings (synergies) from the newly combined firm that increases how much it can afford to pay.

Unaffected share price and date

A complication in calculating the premium paid in a transaction is that oftentimes, rumors of the deal reach the public before the announcement, leading to a run-up in the target share price. In order to accurately calculate a premium, the denominator (i.e. the pre-deal share price) needs to be “unaffected” by the acquisition.

We can determine whether a price was affected by the deal news by observing the trading volume in the days leading up to the announcement date. For example, observe how trading volume appeared normal the day prior to the Microsoft/LinkedIn announcement, followed by a major volume spike and price increase¹ on the announcement date:

LNKD Historical Data						
Date	Price	Open	High	Low	Vol.	Change %
Jun 16, 2016	191.33	191.06	191.66	191.00	3.46M	0.02%
Jun 15, 2016	191.29	191.50	191.77	191.25	5.81M	-0.18%
Jun 14, 2016	191.63	192.28	192.44	191.50	10.90M	-0.30%
Jun 13, 2016	192.21	194.29	194.38	192.16	26.47M	46.64%
Jun 10, 2016	131.08	135.00	135.36	130.90	2.00M	-3.98%
Jun 09, 2016	136.52	136.26	138.89	135.51	2.78M	1.99%
Jun 08, 2016	133.85	134.08	134.57	132.76	936.36K	0.11%
Jun 07, 2016	133.70	136.00	136.12	133.52	986.61K	-1.47%

Source: Investing.com

Deals for which rumors get out will show spikes in trading volume prior to the announcement date. One consequence of this is that when investment bankers calculate purchase premiums, they also calculate the following:

1. Premium over the day prior to announcement
2. Premium over 1 week prior to announcement
3. Premium over 1 month prior to announcement

Real world example

Below is an example of how premiums analysis is presented in practice: On February 4, 2013, Dell's board gathered to make the final decision on whether to approve a Michael Dell-led management buyout (MBO), which is a leveraged buyout (LBO) carried out by the existing management.

Michael Dell, along with private equity firm Silver Lake, was offering \$13.65 per share in cash to each shareholder excluding Michael Dell (he would roll over his equity into the newly-privatized company). Dell's investment banker, Evercore Partners, made the following presentation to the board, which shows the \$13.65 per-share offer price compared to Dell's prior pre-MBO share prices at various dates:

Summary of Current Proposal

Confidential

Transaction Valuation		Premium Analysis					
<i>(\$ in billions, except for per share amounts)</i>							
Offer Price per Share	\$13.65	Premium to Unaffected Date:	Closing Prices		Average Prices	TEV	
			Close	Premium	Average	Premium	Premium ⁽²⁾
Implied Equity Value	\$24.1	Unaffected Price ⁽¹⁾	\$10.88	25.5%	-	36.5%	
Plus: Debt (01/31/13E) ⁽³⁾	9.2	1 Week Prior	10.97	24.4%	\$10.94	24.8%	34.9%
Less: Cash (01/31/13E) ⁽³⁾	(14.9)	2 Week Prior	9.97	36.9%	10.74	27.1%	55.1%
Implied Enterprise Value	\$18.4	3 Months Prior	10.67	27.9%	10.57	29.2%	40.4%
		6 Months Prior	9.35	46.0%	9.94	37.3%	70.9%
		1 Year Prior	12.32	10.8%	10.54	29.5%	14.7%
		2 Years Prior	15.94	(14.4%)	13.01	4.9%	(18.2%)
		52 Week High - at Closing	14.39	(5.1%)	14.14	(3.5%)	(6.7%)
		52 Week Low - at Closing	18.32	(25.5%)	-	-	-
			8.86	54.1%	-	-	-

Implied Transaction Multiples								
	Management		BCG	Productivity Case		Wall Street Research		
	9/21 Case ⁽⁴⁾	BoD Preliminary ⁽⁵⁾	BCG	25%	75%	Low	Street Median	High
Enterprise Value To								
FY 2013E EBITDA	4.1 x	4.1 x	4.2 x	4.2 x	4.2 x	4.1 x	4.1 x	4.1 x
FY 2014E EBITDA	3.9	4.3	4.7	4.6	4.4	4.7	4.4	4.3
FY 2015E EBITDA	3.4	-	4.7	4.3	3.6	5.0	4.7	4.1
Equity Value To								
FY 2013E Net Income	8.1 x	8.1 x	8.4 x	8.4 x	8.4 x	8.1 x	8.1 x	8.1 x
FY 2014E Net Income	8.0	8.9	9.7	9.4	8.9	9.1	8.9	8.2
FY 2015E Net Income	6.6	-	9.9	8.7	7.0	9.6	9.2	7.6
FY 2013E CFO - Capex	10.5 x	-	13.6 x	13.6 x	13.6 x	14.1 x	15.4 x	14.6 x
FY 2014E CFO - Capex	7.6	-	10.4	10.1	9.6	14.9	11.9	10.0
FY 2015E CFO - Capex	6.7	-	10.5	9.2	7.5	19.0	13.3	9.3

Note: EBITDA includes stock-based compensation expense; EBITDA and Net Income exclude the impact of one-time charges; Dell's fiscal year closes on January 31*
 (1) As per 9/21 Case
 (2) TEV calculated assuming net debt position and projected share count and in-the-money options as of end of Q2FY14
 (3) Throughout this presentation, the Unaffected Price represents the closing price of Dell's shares on 01/11/13 (the Unaffected Date), the day prior to media rumors of a potential transaction
 (4) FY13 EBITDA and Net Income provided by Dell's Management on 02/01/13; FY14 EBITDA and Net Income based on Dell's Management's FY14 Internal Plan. Assumes FDSO as provided in 9/21 Case
 (5) FY13 figures provided by Dell's Management on 02/01/13; FY14 figures from Preliminary Proposed Board Plan for FY14 provided by Dell's Management on 01/18/13. Assumes FDSO as provided in 9/21 Case
 Source: Dell's Management, BCG, FactSet, Wall Street Research

As you can see, the premium was determined to be 25.5%, based on an unaffected share price of \$10.88 on 1/1//2013. As you can see, Evercore set the unaffected price at a date several weeks before the announcement because rumors of the deal had leaked out.

In contrast, when Microsoft acquired LinkedIn, the unaffected date was simply the day before the acquisition, as trading volume and share price activity suggested no rumors had gotten out.

Premiums paid analysis

Later on in the presentation, Evercore also presents a premiums paid analysis — a common analysis made by investment bankers when advising a public target. The premiums paid analysis reviews historical transactions comparable to the active deal and averages the premiums paid for those transactions. Presumably, the average of the premiums from those deals should be near where the active deal should end up.

The output in Dell’s case, as you can see below, are premiums for comparable transactions in the mid 20% – exactly in line with the 25.5% premium being offered.

Premiums Paid Analysis: Closed Acquisitions in Last 10 Years Globally with Target TEV greater than \$10 billion

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All Transactions				All Cash Transactions			
Number of Transactions	126			Number of Transactions	50		
	Premium Paid				Premium Paid		
	1 Day Prior	1 Week Prior	4 Weeks Prior		1 Day Prior	1 Week Prior	4 Weeks Prior
Median	24.5%	27.2%	28.0%	Median	28.0%	30.0%	32.8%
High	116.4%	123.6%	118.7%	High	116.4%	123.6%	118.7%
75th Percentile	37.1%	39.9%	40.6%	75th Percentile	43.3%	51.1%	51.8%
Mean	27.7%	30.3%	32.2%	Mean	33.8%	36.3%	38.8%
25th Percentile	13.0%	15.7%	18.4%	25th Percentile	18.9%	18.9%	21.9%
Low	0.1%	1.0%	1.9%	Low	0.4%	1.0%	5.7%

Strategic Buyers				Buyer is a Financial Sponsor			
Number of Transactions	103			Number of Transactions	23		
	Premium Paid				Premium Paid		
	1 Day Prior	1 Week Prior	4 Weeks Prior		1 Day Prior	1 Week Prior	4 Weeks Prior
Median	27.9%	28.4%	30.8%	Median	20.1%	22.8%	26.0%
High	116.4%	123.6%	118.7%	High	45.1%	50.8%	47.2%
75th Percentile	38.0%	41.5%	43.0%	75th Percentile	31.2%	31.8%	33.1%
Mean	28.9%	31.7%	33.7%	Mean	22.1%	24.3%	25.6%
25th Percentile	14.1%	16.5%	17.9%	25th Percentile	10.5%	14.3%	19.6%
Low	0.1%	1.0%	3.3%	Low	4.4%	2.8%	1.9%

Note: Data excludes Banks, REITs and other financial services target companies
Source: FactSet, SDC

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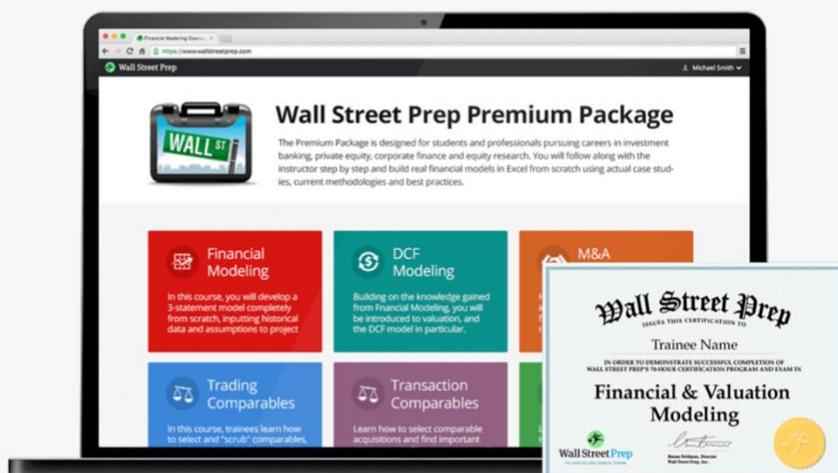
After Dell and Silver Lake completed the buyout, shareholders who voted against the sale successfully sued Dell, arguing that the premium offered was insufficient. This ruling was later overturned, but not before sending shockwaves throughout the M&A world.

Finding historical prices for delisted stocks

Historical share prices for companies that have been acquired, and thus delisted, aren't as widely available as current actively traded shares. For example, once LinkedIn delisted at the close of the sale, most free services like Yahoo Finance no longer provided its share price data.

Subscription-based financial data providers like CapitalIQ, Factset, Bloomberg and Thomson do keep historical prices for delisted companies, as do some lesser known free services such as historicalstockprice.com and investing.com.

Notice that LinkedIn's share price jumped to \$192.21, whereas the offer price was \$196. Upon an acquisition announcement, target shares often creep towards the offer price, but usually don't get there. [Click here to learn why](#).



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Tender Offer vs. Merger

Contrasting the structure of the most acquisition strategies

A statutory merger (aka “traditional” or “one step” merger)

A traditional merger is the most common type of public acquisition structure. A merger describes an acquisition in which two companies jointly negotiate a merger agreement and legally merge.

Target shareholder approval is required

The target board of directors initially approves the merger and it subsequently goes to a shareholder vote. Most of the time a majority shareholder vote is sufficient, although some targets require a supermajority vote per their incorporation documents or applicable state laws.

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Over 50% of all US companies are incorporated in Delaware, where majority voting is the law.

Buyer shareholder approval required when paying with > 20% stock

An acquirer can either use cash or stock or a combination of both as the purchase consideration. An acquirer may also need shareholder approval if it issues more than 20% of its stock in the deal. That’s because the NYSE, NASDAQ and other exchanges require it. Buyer shareholder vote is not required if the consideration is in cash or less than 20% of acquirer stock is issued in the transaction.

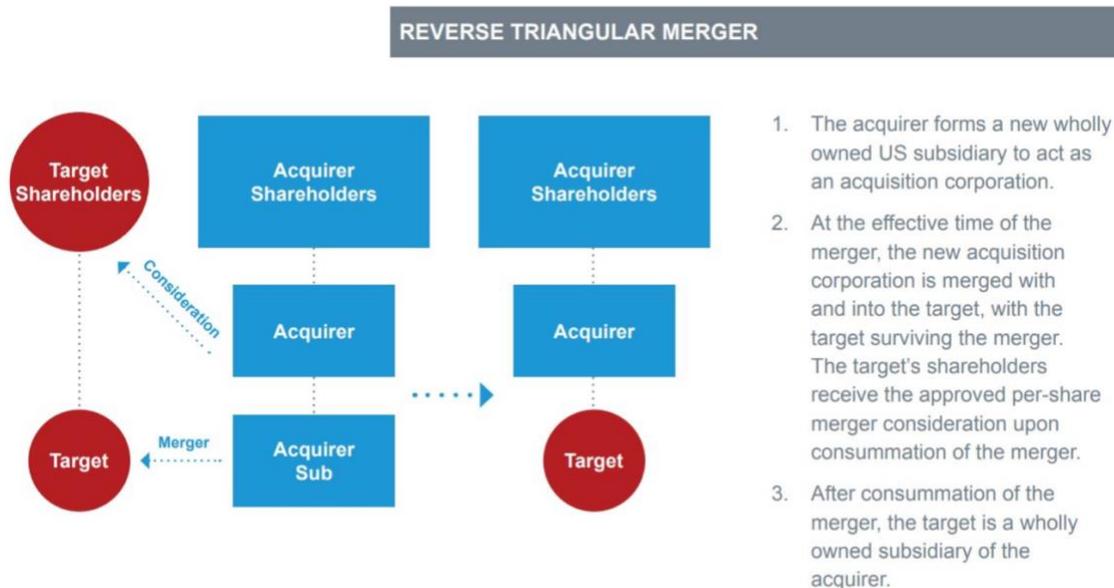
Example of a merger

Microsoft's acquisition of LinkedIn in June 2016 is an example of a traditional merger: LinkedIn management ran a sell-side process and invited several bidders including Microsoft and Salesforce. LinkedIn signed a merger agreement with Microsoft and then issued a merger proxy soliciting shareholder approval (no Microsoft shareholder approval was required since it was an all-cash deal).

The primary advantage of structuring a deal as a merger (as opposed to the two-step or tender offer structure we'll describe below) is that acquirer can get 100% of the target without having to deal with each individual shareholder – a simple majority vote is sufficient. That's why this structure is common for acquiring public companies.

Legal mechanics of a merger

After the target shareholders approve the merger, target stock is delisted, all shares are exchanged for cash or acquirer stock (in LinkedIn's case it was all cash), and target shares are cancelled. As a legal fine point, there are several ways to structure a merger. The most common structure is a reverse triangular merger (aka reverse subsidiary merger), in which the acquirer sets up a temporary subsidiary into which the target is merged (and the subsidiary is dissolved):



Source: Latham & Watkins

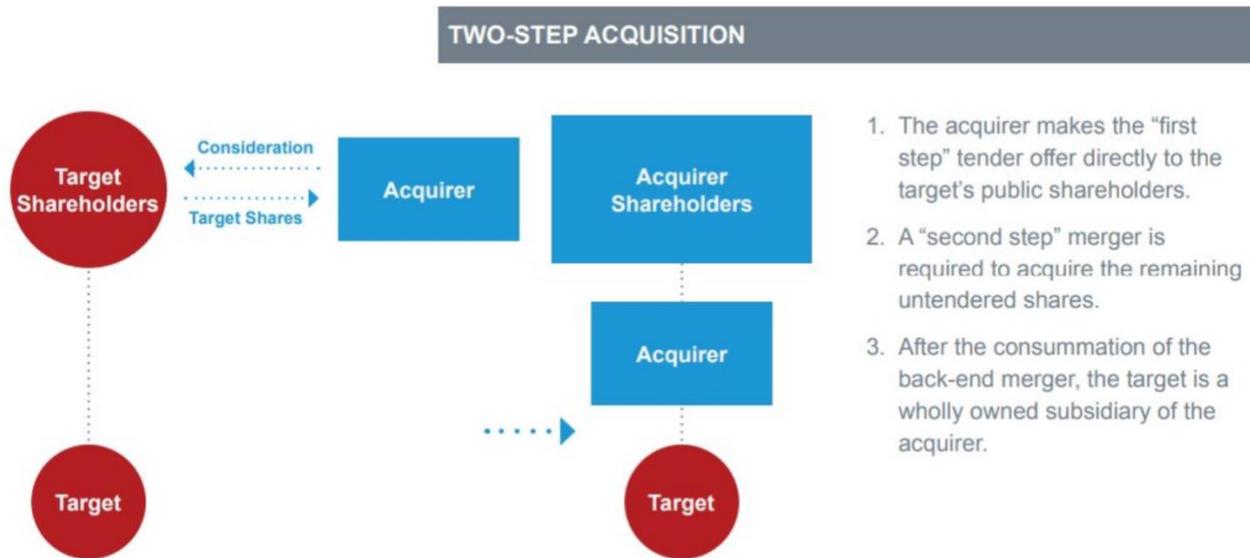
Tender offer or exchange offer (aka “two-step merger”)

In addition to the traditional merger approach described above, an acquisition can also be accomplished with the buyer simply acquiring the shares of the target by directly and publicly offering to acquire them. Imagine that instead of an acquirer negotiating with LinkedIn management, they simply went directly to shareholders and offered them cash or stock in exchange for each LinkedIn share. This is called a tender offer (if the acquirer offers cash) or an exchange offer (if the acquirer is offering stock).

- **Main advantage: Acquirers can bypass the seller's management and board**
One distinct advantage of purchasing stock directly is that it allows buyers to bypass management and the board of directors entirely. That’s why hostile takeovers are almost always structured as a stock purchase. But a stock purchase can be attractive even in a friendly transaction in which there are few shareholders, accelerating the process by avoiding the otherwise required management and board meetings and shareholder vote.
- **Main disadvantage: Acquirers have to deal with potential holdouts**
The challenge with purchasing target stock directly is that to gain 100% control of the company, the acquirer must convince 100% of the shareholders to sell their stock. If there are holdouts (as there almost certainly would be for companies with a diffuse shareholder base), the acquirer can also gain control with a majority of shares, but it will then have minority shareholders. Acquirers generally prefer not to deal with minority shareholders and often seek to gain 100% of the target.

Two-step merger

Barring a highly concentrated shareholder base which would facilitate a complete 100% purchase in one step (workable for private targets with a few shareholders that can be directly negotiated with), stock purchases are affected via what’s called a two-step merger. The first step is the tender (or exchange) offer, where the buyer seeks to achieve a majority ownership, and the second step seeks to get ownership to 100%. In this step, the acquirer needs to reach a certain ownership threshold that legally empowers it to squeeze out minority shareholders (illustrated below).



Source: Latham & Watkins

Step one: tender offer or exchange offer

To initiate the tender offer, the buyer will send an “Offer to Purchase” to each shareholder and file a Schedule TO with the SEC with the tender offer or exchange offer attached as an exhibit. In response, the target must file its recommendation (in schedule 14D-9) within 10 days. In a hostile takeover attempt, the target will recommend against the tender offer. This is where you may see the rare fairness opinion that claims a transaction isn't fair.

The buyer will condition their commitment to follow through with the purchase on reaching a certain threshold of target shareholder participation by a specified date (usually at least 20 days from the tender offer). Usually that threshold is a majority (> 50%), which is the minimum required to legally move to the next step without having to negotiate with minority shareholders.

Step two: back-end (or “squeeze out”) merger

Achieving at least 50% ownership after the tender offer enables the acquirer to proceed with a back-end merger, a second step which forces the minority shareholders to convert their shares for the consideration offered by the acquirer.

Long form merger

When more than 50% but less than 90% of shares were acquired in the tender offer, the process is called a long form merger and involves additional filing and disclosure requirements on the part of the acquirer. A successful outcome for the acquirer, however, is generally assured; it just takes a while.

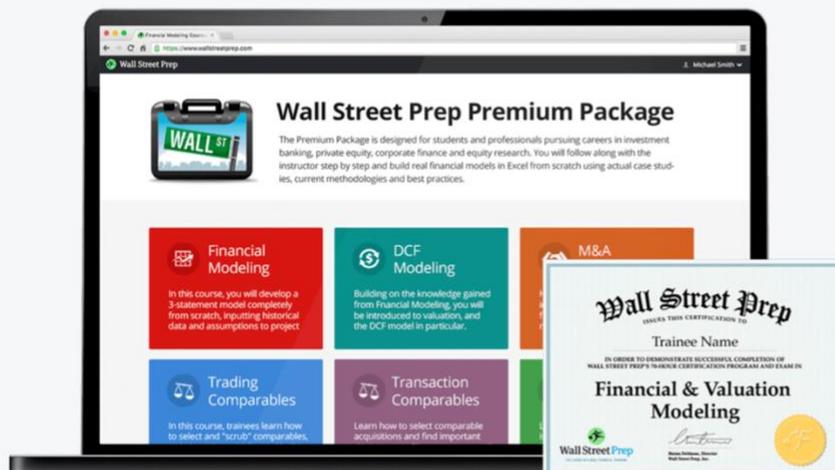
Short form merger

Most states allow an acquirer that has been able to purchase at least 90% of the seller stock through the tender offer to get the remainder quickly in a second step without onerous additional SEC disclosures and without having to negotiate with the minority shareholders in what's called a short form merger.

"If a buyer acquires less than 100% (but generally at least 90%) of a target company's outstanding stock, it may be able to use a short-form merger to acquire the remaining minority interests. The merger allows the buyer to acquire those interests without a stockholder vote, thereby purchasing all of the target company's stock. This merger process occurs after the stock sale closes, and is not a negotiated transaction."

Source: Thomas WestLaw

Notably, Delaware allows acquirers (upon meeting certain conditions) to do a short form merger with just majority (> 50%) ownership. This allows acquirers to bypass shareholder approval at the 50% threshold rather than 90%. Most other states still require 90%.



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Asset Sale vs. Stock Sale

A review of buyer and seller preferences for M&A transactions

When one company acquires another company, what does the seller actually give the buyer? The answer depends on whether the deal is structured legally as a stock sale or as an asset sale. Broadly speaking:

1. In a stock sale, the seller gives the buyer shares. Once the buyer holds all the target shares, it controls the business by virtue of being its new owner.
2. In an asset sale, the seller gives the buyer assets. Once the buyer holds all the assets, it controls the business by virtue of having everything that made the seller's equity worth something in the first place. So, even though the buyer doesn't have the seller's shares, it doesn't matter because the buyer has everything that made those shares worth something.



The decision to structure a deal as a stock sale or an asset sale is usually a joint decision by the buyer and seller. For a variety of legal, accounting and tax reasons, some deals make more sense as stock deals while others make more sense as asset deals. Often, the buyer will prefer an asset sale while the seller will prefer a stock sale. The decision on which to go with becomes part of the negotiations: Often, the party that gets their way concedes a bit on the purchase price or on some other facet of the deal.

Stock sales

When Microsoft acquired LinkedIn on June 13, 2016, what Microsoft was acquiring with its cash was LinkedIn stock. We know this because the announcement press release, merger agreement and merger proxy all describe how Microsoft is buying LinkedIn shares. Both approaches conceptually get you to the same place, but certain legal, tax and accounting issues make this decision important.

Per the proxy, at deal closing, each LinkedIn shareholder was set to receive \$196 in cash for each of their shares, which would then immediately be cancelled:

At the effective time of the merger, each outstanding share of Class A and Class B common stock (collectively referred to as "common stock") (other than shares held by (1) LinkedIn as treasury stock; (2) Microsoft, Merger Sub or their respective subsidiaries; and (3) LinkedIn stockholders who have properly and validly exercised and perfected their appraisal rights under Delaware law with respect to such shares) will be cancelled and automatically converted into the right to receive the per share merger consideration (which is \$196.00 per share, without interest thereon and subject to applicable withholding taxes).

Source: LinkedIn merger proxy

Asset sales: an alternative to stock sales

However, there is another way to acquire a company: acquiring all of its assets and assuming its liabilities. Theoretically, whether you acquire 100% of a target's stock ("stock sale") or all assets and liabilities ("asset sale") and leave the now-worthless stock untouched gets you to the same place: You own the entire thing. Using LinkedIn, we can illustrate the equivalence:

1. Deal structured as a stock sale (what actually happened): Each shareholder gets \$196, there are approximately 133 million shareholders, for a total value of \$27.2 billion. LinkedIn shares are cancelled and cease to exist.
2. Deal structured as an asset sale: Microsoft buys all of LNKD's assets, including IP and intangible assets, and assumes all of LinkedIn's liabilities for a total of \$27.2 billion. LinkedIn (the company – not the shareholders) gets the \$27.2 billion. LinkedIn (the company) issues a dividend to shareholders which amounts to \$196 per share (assuming no taxes are paid at the corporate level on the gain on sale). The shares don't get cancelled, but since after the dividend they are now shares in an empty corporate shell with no assets or liabilities, they are worthless and the company can be liquidated.

When NetApp acquired LSI's Engenio, it was structured as an asset sale. The press release gives you a clue into this by not describing the purchase price in per-share terms but rather as a total amount:

NetApp (NASDAQ: NTAP) today announced that it has entered into a definitive agreement to purchase the Engenio® external storage systems business of LSI Corporation (NYSE: LSI) ... in an all-cash transaction for \$480 million.

Source: NetApp Press Release

We can confirm that it is an asset sale by looking at an 8K filed a week after the announcement, which states:

On March 9, 2011, NetApp ... entered into an Asset Purchase Agreement ... by and between LSI Corporation ... and the Company pursuant to which the Company has agreed to acquire certain assets related to LSI's Engenio external storage system business ... as consideration for the Engenio Business, the Company will pay to LSI \$480 million in cash and assume specified liabilities related to the Engenio Business.

Source: NetApp Merger Agreement

The contract in a stock sale is usually called (as it was in the LinkedIn deal) the **Agreement and Plan of Merger** or **Stock Purchase Agreement**. In an asset sale, the contract is called a **Asset Purchase Agreement** or **Purchase and Sale Agreement**.

Tax, legal and accounting issues in stock vs. asset sales

While our simple example shows how asset sales and stock sales lead to the same results, certain legal, tax and accounting issues make this decision important:

Deal structure	Main benefit	Bottom line
Stock sales	Avoid a corporate-level tax: Most deals are structured as stock sales because unlike our simplified assumption, sellers usually face tax on the gain on sale, leading to a second level of tax in an asset sale above the shareholder-level capital gains tax.	Seller happy
Asset sales	Gives buyer future tax savings via stepped-up tax basis: In light of the additional tax on seller, you might be wondering why anyone would ever do an asset sale. The most common reason is that the acquirer gets to step up the tax basis of the acquired target assets. That means future tax savings through higher tax-deductible depreciation and amortization in the future.	Buyer happy

DEEP DIVE: Asset Sale vs Stock Sale

[Click here](#) to learn how to model and analyze the impact of stock vs asset sales on acquisitions.

Deal Documents: Where to Find Information About M&A Transactions

When analyzing M&A transactions, finding the relevant documents is often the hardest part of the job. In an acquisition of a public target, the type of publicly available documents depends on whether the deal is structured as a merger or a tender offer.

M&A documents in deals structured as mergers

Deal announcement press release

When two companies merge, they will jointly issue a press release announcing the merger. The press release, which will be filed with the SEC as an 8K (likely on the same day), will usually include detail about the purchase price, form of consideration (cash vs stock), the expected accretion/dilution to the acquirer and expected synergies, if any. For example, when LinkedIn was acquired by Microsoft in June 13, 2016, they first broke the news to the public via [this press release](#).



Definitive agreement

Along with the press release, the public target will also file the definitive agreement (usually as an exhibit to the press release 8-K or sometimes as a separate 8-K). In a stock sale, the agreement is often called the merger agreement, while in an asset sale, it's often called an asset purchase agreement.

The agreement lays out the terms of the deal in more detail. For example, the LinkedIn [merger agreement](#) details:

- Conditions that would trigger the break-up fee
- Whether the seller can solicit other bids ("go-shop" or "no-shop")

- Conditions that would allow a buyer to walk away ("material adverse effects")
- How shares will be converted to acquirer shares (when buyer pays with stock)
- What happens to the seller's options and restricted stock

Merger proxy (DEFM14A/PREM14A)

A proxy is an SEC filing (called the 14A) that is required when a public company does something that its shareholders have to vote on, such as getting acquired. For a vote on a proposed merger, the proxy is called a **merger proxy** (or a **merger prospectus** if the proceeds include acquirer stock) and is filed as a DEFM14A.

A public seller will file the merger proxy with the SEC usually several weeks after a deal announcement. You'll first see something called a PREM14A, followed by a DEFM14A several days later. The first is the **preliminary proxy**, the second is the **definitive proxy** (or final proxy). The specific number of shares that are eligible to vote and the actual date of the proxy vote are left blank as placeholders in the preliminary proxy. Otherwise, the two generally contain the same material.

What's included

Various elements of the merger agreement (deal terms and consideration, treatment of dilutive securities, breakup fees, MAC clause) are summarized and are more clearly laid out in the merger proxy than in the legal jargon-heavy merger agreement. The proxy also includes critical detail on the background of the merger, the fairness opinion, the seller's financial projections, and the compensation and post-deal treatment of seller's management.

Here is LinkedIn's merger proxy, filed July 22, 2016, 6 weeks after deal announcement.

Information statement (PREM14C and DEFM14C)

Targets in certain mergers will file the PREM14C and the DEFM14C instead of the DEFM14A/PREM14A. This happens when one or more shareholders hold a majority of the shares and are able to provide approval without a full shareholder vote through written consent. The documents will contain similar information to the regular merger proxy.

M&A documents in deals structured as tender offers and exchange offers

The buyer's tender offer: Schedule TO

To initiate a tender offer, the buyer will send an “Offer to Purchase” to each shareholder. The target must file a Schedule TO with the SEC, with the tender offer or exchange offer attached as an exhibit. The Schedule TO will contain key deal terms.

In May 2012, GlaxoSmithKline sought to acquire Human Genome Sciences for \$13.00 in cash per share in a hostile takeover bid via [this tender offer](#).

The target board's response to a tender offer: Schedule 14D-9

The target's board must file their recommendation (in a schedule 14D-9) in response to the tender offer within 10 days. In a hostile takeover attempt, the target will recommend against the tender offer. Here is Human Genome's [14D-9 recommending against the tender offer](#).

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the Schedule 14D-9's response to unsolicited hostile tender offers is where you'll see the rare fairness opinion that claims a transaction isn't fair.

Prospectus

When new shares are issued as part of a merger or exchange offer, a registration statement (S-4) will be filed by the acquirer, requesting that the acquirer's own shareholders approve the issuance of shares. Sometimes, a registration statement will also include the target merger proxy and will be filed as a joint proxy statement/prospectus. The S-4 usually contains the same detailed information as the merger proxy. Like the merger proxy, it is usually filed several weeks after the transaction is announced.

Prospectus vs merger proxy

As an example, 3 months after Procter & Gamble announced it was acquiring Gillette, it filed an S-4 with the SEC. It included both the preliminary joint proxy statement and prospectus. The definitive merger proxy was filed by Gillette 2 months later. In this case, since the proxy was filed later, it contained more updated detail, including projections. Otherwise, the material was largely identical.

Generally, you want to go with the most recently filed document, as it contains the most updated information.

Summary of key M&A documents for finding deal terms of public targets

Acquisition type	Document	Date filed	Best place to find it
Mergers	Press release	Announcement date	<ol style="list-style-type: none"> 1. Target (likely also acquirer) will file SEC form 8K (could be in an 8K exhibit) 2. Target (likely also acquirer) website 3. Financial data providers
Mergers	Definitive agreement	Announcement date	<ol style="list-style-type: none"> 1. Target 8K (often the same 8K that contains press release) 2. Financial data providers
Mergers	Merger proxy	Several weeks after the announcement date	<ol style="list-style-type: none"> 1. Target PREM14A and DEFM14A 2. Financial data providers
Tender/exchange offers	Tender offer (or exchange offer)	Upon initiation of tender offer	<ol style="list-style-type: none"> 1. Target Schedule TO (attached as exhibit) 2. Financial data providers
Tender/exchange offers	Schedule 14D-9	Within 10 days of filing of Schedule TO	<ol style="list-style-type: none"> 1. Target Schedule 14D-9 2. Financial data providers
Mergers and exchange offers	Registration statement/prospectus	Several weeks after the announcement date	<ol style="list-style-type: none"> 1. Acquirer Form S-4 2. Financial data providers

Breakup Fees and Reverse Termination Fees in M&A

Breakup fees

A breakup fee refers to a payment a seller owes a buyer should a deal fall through due to reasons explicitly specified in the merger agreement. For example, when Microsoft acquired LinkedIn in June 13, 2016, Microsoft negotiated a \$725 million breakup fee should any of the following happen:

1. LinkedIn Board of Directors changes its mind
2. More than 50% of company's shareholders don't approve the deal
3. LinkedIn goes with a competing bidder (called an "interloper")



Breakup fees protect buyers from very real risks

There's good reason for buyers to insist on a breakup fees: The target board is legally obligated to try to get the best possible value for their shareholders. That means that if a better offer comes along after a deal is announced (but not yet completed), the board might be inclined, due to its fiduciary obligation to target shareholders, to reverse its recommendation and support the new higher bid.

The breakup fee seeks to neutralize this and protect the buyer for the time, resources and cost already poured into the process.

This is particularly acute in public M&A deals where the merger announcement and terms are made public, enabling competing bidders to emerge. That's why breakup fees are common in public deals, but not common in middle market deals.

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Breakup fees usually range from 1-5% of the transaction value

Reverse termination fees

While buyers protect themselves via breakup (termination) fees, sellers often protect themselves with reverse termination fees (RTFs). As the name suggests, RTFs allow the seller to collect a fee should the buyer walk away from a deal.

Risks faced by the seller are different from the risks faced by the buyer. For example, sellers generally don't have to worry about other bidders coming along to spoil a deal. Instead, sellers are usually most concerned with:

1. Acquirer not being able to secure financing for the deal
2. Deal not getting antitrust or regulatory approval
3. Not getting buyer shareholder approval (when required)
4. Not completing the deal by a certain date ("drop dead date")

For example, when Verizon Communications acquired Vodafone's interest in Verizon Wireless in 2014, Verizon Communications agreed to pay a \$10 billion RTF should it be unable to secure financing for the purchase.

However, in the Microsoft/LinkedIn deal we referenced earlier, LinkedIn did not negotiate an RTF. That's likely because financing (Microsoft has \$105.6 billion in cash on hand) and antitrust trust concerns were minimal.

Reverse termination fees are most prevalent with financial buyers

Concerns about securing financing tend to be most common with financial buyers (private equity), which explains why RTFs are prevalent in non-strategic deals (i.e. the buyer is private equity).

A [Houlihan Lokey survey](#) looking at 126 public targets found that an RTF was included in only 41% of deals with a strategic buyer but included in 83% of deals with a financial buyer. In addition, the fees as a percentage of the target enterprise value are also higher for financial buyers: 6.5% as compared to 3.7% for strategic buyers.

The reason for the higher fees is that during the financial crisis, RTFs were set too low (1-3% of deal value), so private equity buyers found it was worth paying the fine to walk away from companies in meltdown.

RTF + specific performance

In addition to the RTF, and perhaps more importantly, sellers have demanded (and largely received) the inclusion of a provision called "**conditional specific performance.**" Specific performance contractually empowers the seller to force the buyer to do what the agreement requires, hence making it much harder for private equity buyers to get out of a deal.

"allows a seller to "specifically enforce (1) the buyer's obligation to use its efforts to obtain the debt financing (in some cases, including by suing its lenders if necessary) and (2) in the event that the debt financing could be obtained using appropriate efforts, to force the buyer to close. Over the past several years, that approach has become the dominant market practice to address financing conditionality in private equity-led leveraged acquisitions.

Source: Debevosie & Plimpton, Private Equity Report, Vol 16, Number 3

Both RTF and the conditional specific performance provisions are now the prevalent way that sellers protect themselves – especially with financial buyers.

No-Shop and Go-Shop in M&A

How buyers and sellers deal with competing bids after signing the merger agreement

The no-shop provision

When Microsoft acquired LinkedIn on June 13, 2016, the press release disclosed that the breakup fee would take effect if LinkedIn ultimately consummates a deal with another buyer. Page 56 of the [Microsoft/LinkedIn merger agreement](#) describes in detail the limitation on LinkedIn's ability to solicit other offers during the period between when the merger agreement was signed and when the deal will close.

This section of the merger agreement is called "No Solicitation," and is more commonly known as a "no-shop" provision. No-shops are designed to protect the buyer from the seller continuing to accept bids and using the buyer's bid to improve its position elsewhere.

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No-Shops are included in the majority of deals.

For LinkedIn, the violation of the no-shop would trigger a \$725 million breakup fee. According to M&A law firm [Latham & Watkins](#), no-shops typically prevent the target from conducting the following activities in the period between signing and closing:

- Soliciting alternative acquisition proposals
- Offering information to potential buyers
- Initiating or encouraging discussions with potential buyers
- Continuing ongoing discussions or negotiations

- Waiving outstanding standstill agreements with third parties (this makes it harder for losing bidders to come back in)

Superior proposal

While no-shops place severe limitations on shopping the deal, target boards have a fiduciary responsibility to maximize offer value for shareholders, so they generally cannot refuse to respond to unsolicited offers.

That's why the no-shop clause almost always has an exception around unsolicited superior offers. Namely, if target determines that the unsolicited offer is likely to be "superior," it can engage. From LinkedIn's merger proxy:

A "superior proposal" is a bona fide written acquisition proposal ... for an acquisition transaction on terms that the LinkedIn Board has determined in good faith (after consultation with its financial advisor and outside legal counsel) would be more favorable from a financial point of view than the merger. ...

The buyer usually has the right to match the offer and to gain full visibility on the discussions:

... and taking into account any revisions to the merger agreement made or proposed by Microsoft prior to the time of such determination and after taking into account the other factors and matters deemed relevant in good faith by the LinkedIn Board, including the identity of the person making the proposal, the likelihood of consummation, and the legal, financial (including financing terms), regulatory, timing and other aspects of the proposal.

Of course, if the superior proposal is accepted, LinkedIn still has to pay the termination fee (which means any offer must be sufficiently superior as to be worth the termination fee):

LinkedIn is not entitled to terminate the merger agreement to enter into an agreement for a superior proposal unless it complies with certain procedures in the merger agreement, including engaging in good faith negotiations with Microsoft during a specified period. If LinkedIn terminates the merger agreement in order to accept a superior proposal, it must pay a \$725 million termination fee to Microsoft.

In the Microsoft/LinkedIn acquisition, the no-shop was an important part of the negotiation, as Microsoft was weary of other suitors, namely Salesforce. Ultimately, the no-shop held, but it did not prevent Salesforce from trying to come in with a higher unsolicited proposal bid for LinkedIn after the deal, forcing Microsoft to up the ante.

The go-shop provision

The vast majority of deals have no-shop provisions. However, there is an increasing minority of deals in which targets are allowed to shop around for higher bids after the deal terms are agreed upon.

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Go-shops generally only appear when the buyer is a financial buyer (PE firm) and the seller is a private company. They are increasingly popular in go-private transactions, where a public company undergoes an LBO. A 2017 study conducted by law firm Weil reviewed 22 go-private transactions with a purchase price above \$100 million and found that 50% included a go-shop provision.

Go-shops allows sellers to seek competitive bids despite an exclusive negotiation

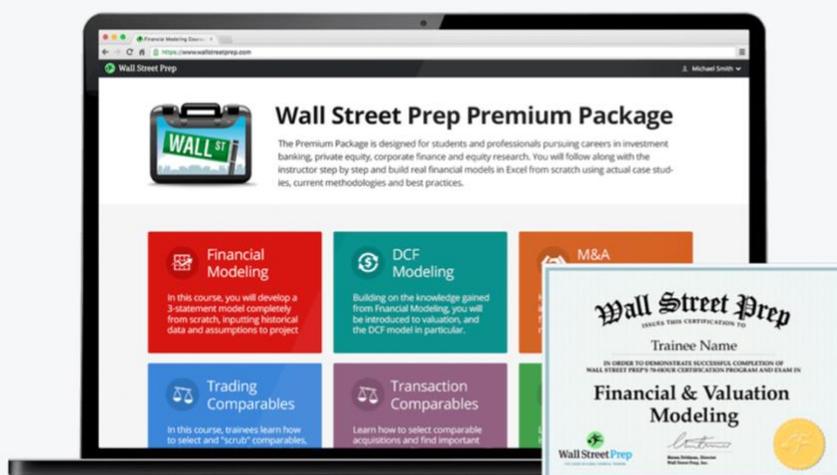
From target shareholders' point of view, the ideal way to sell is to run a sell-side process in which the company solicits several buyers in an effort to maximize the deal value. That happened (somewhat) with LinkedIn – there were several bidders.

But when the seller doesn't run a "process" – meaning when it engages with a single buyer only — it is vulnerable to arguments that it did not meet its fiduciary responsibility to shareholders by failing to see what else is out there.

When this is the case, the buyer and seller can negotiate a go-shop provision which, in contrast to the no-shop, gives the seller the ability to actively solicit competing proposals (usually for 1-2 months) while keeping it on the hook for a lower breakup fee should a superior proposal emerge.

Do go-shops actually do what they're supposed to?

Since the go-shop provision rarely leads to an additional bidder emerging, it is often criticized as being "window dressing" that stacks the deck in favor of the incumbent buyer. However, there have been exceptions where new bidders have emerged.



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Material Adverse Change: The ABCs of MACs

A guide to the use of material adverse change clauses in M&A

A material adverse change (MAC) is one of several legal mechanisms used to reduce risk and uncertainty for buyers and sellers during the period between the date of the merger agreement and the date the deal closes. MACs are legal clauses that buyers include in virtually all merger agreements that outline conditions that might conceivably give the buyer the right to walk away from a deal. Other deal mechanisms that address the gap-period risks for buyers and sellers include no-shops and purchase price adjustments as well as break up fees and reverse termination fees.



You're thinking about a different MAC

Introduction to MAC Clauses

In our guide to mergers & acquisitions, we saw that when Microsoft acquired LinkedIn on June 13, 2016, it included a \$725 million break-up fee that LinkedIn would owe Microsoft if LinkedIn changed its mind prior to the closing date.

Notice that the protection given to Microsoft via the breakup fee is one-directional — there are no breakup fees owed to LinkedIn should Microsoft walk away. That's because the risk that Microsoft will walk away is lower. Unlike LinkedIn, Microsoft doesn't need to get shareholder approval. A common source of risk for sellers in M&A, especially when the buyer is a private equity buyer, is the risk that buyer can't secure financing. Microsoft has ample cash, so securing financing isn't an issue.

That's not always the case, and sellers often protect themselves with reverse termination fees.

However, that doesn't mean Microsoft can simply walk away for no reason. At the deal announcement, the buyer and seller both sign the merger agreement, which is a binding contract for both the buyer and seller. If the buyer walks away, the seller will sue.

So are there any circumstances in which the buyer can walk away from the deal? The answer is yes. ... kind of.

The ABCs of MACs

In an effort to protect themselves against unforeseen changes to the target's business during the gap period, virtually all buyers will include a clause in the merger agreement called the material adverse change (MAC) or material adverse effect (MAE). The MAC gives the buyer the right to terminate the agreement if the target experiences a material adverse change to the business.

Unfortunately, what constitutes a material adverse change is not clear cut. According to Latham & Watkins, courts litigating MAC claims focus on whether there is substantial threat to overall earnings (or EBITDA) potential relative to past performance, not projections. The threat to EBITDA is typically measured using long-term perspective (years, not months) of a reasonable buyer, and the buyer bears the burden of proof.

Unless the circumstances that trigger a MAC are very well defined, courts generally are loath to allow acquirers to back out of a deal via a MAC argument. That said, acquirers still like to include a MAC clause to improve their bargaining position with a litigation threat should problems with the target emerge post announcement.

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As one might imagine, during the financial meltdown in 2007-8, many acquirers tried to back out of deals in which the targets were melting down using the MAC clause. These attempts were largely denied by courts, with Hexion's acquisition of Huntsman being a good example. Hexion tried to back out of the deal by claiming a material adverse change. The claim didn't hold up in court and Hexion was forced to compensate Huntsman handsomely.

Common exclusions in MACs

MACs are heavily negotiated and are usually structured with a list of exclusions that don't qualify as material adverse changes. Perhaps the largest difference between a buyer-friendly and seller-friendly MAC is that the seller friendly MAC will carve out a large number of detailed exceptions of events that do NOT qualify as a material adverse change.

For example, the exclusions (events that explicitly won't count as triggering a MAC) in the LinkedIn deal (p.4-5 of the merger agreement) include:

- Changes in general economic conditions

Appendices

- Changes in conditions in the financial markets, credit markets or capital markets
- General changes in conditions in the industries in which the Company and its Subsidiaries conduct business, changes in regulatory, legislative or political conditions
- Any geopolitical conditions, outbreak of hostilities, acts of war, sabotage, terrorism or military actions
- Earthquakes, hurricanes, tsunamis, tornadoes, floods, mudslides, wild fires or other natural disasters, weather conditions
- Changes or proposed changes in GAAP
- Changes in the price or trading volume of the Company common stock
- Any failure, in and of itself, by the Company and its Subsidiaries to meet (A) any public estimates or expectations of the Company's revenue, earnings or other financial performance or results of operations for any period
- Any transaction litigation

Exchange Ratio in M&A: Fixed vs Floating Exchange Ratios, Collars and Caps

For a deal structured as a stock sale (as opposed to when the acquirer pays with cash — read about the difference [here](#)), the exchange ratio represents the number of acquirer shares that will be issued in exchange for one target share. Since acquirer and target share prices can change between the signing of the [definitive agreement](#) and the closing date of a transaction, deals are usually structured with:

A fixed exchange ratio: the ratio is fixed until closing date. This is used in a majority of U.S. transactions with deal values over \$100 million.

A floating exchange ratio: The ratio floats such that the target receives a fixed value no matter what happens to either acquirer or target shares.

A combination of a fixed and floating exchange, using caps and collars.

The specific approach taken is decided in the negotiation between buyer and seller. Ultimately, the exchange ratio structure of the transaction will determine which party bears most of the risk associated with pre-close price fluctuation. The differences described above can be broadly summarized as follows:

Fixed exchange ratio

- Shares issued are known
- Value of transaction is unknown
- Preferred by acquirers because the issuance of a fixed number of shares results in a known amount of ownership and [earnings accretion or dilution](#)

Floating exchange ratio

- Value of transaction is known
- Shares issued are unknown
- Preferred by sellers because the deal value is defined (i.e. the seller knows exactly how much it is getting no matter what)

Fixed exchange ratio

Below is a fact pattern to demonstrate how fixed exchange ratios work.

Terms of the agreement

The target has 24 million shares outstanding with shares trading at \$9; The acquirer shares are trading at \$18.

On January 5, 2014 (“announcement date”) the acquirer agrees that, upon completion of the deal (expected to be February 5, 2014) it will exchange .6667 of a share of its common stock for each of the target’s 24 million shares, totaling 16m acquirer shares.

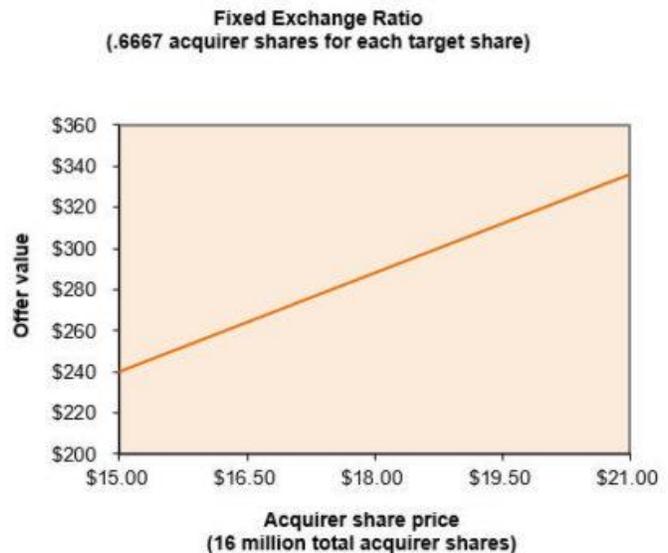
No matter what happens to the target and acquirer share prices between now and February 5, 2014, the share ratio will remain fixed.

On announcement date, the deal is valued at: 16m shares * \$18 per share = \$288 million. Since there are 24 million target shares, this implies a value per target share of \$288 million/24 million = \$12. That’s a 33% premium over the current trading price of \$9.

Announcement Date: 1/5/14
Target Share Price: \$9
Acquirer Share Price: \$18
Closing Date: 2/5/14
Target Share Price: \$12
Acquirer Share Price: \$18

Acquirer share price drops after announcement

- By February 5, 2014, the target’s share price jumps to \$12 because target shareholders know that they will shortly receive .6667 acquirer shares (which are worth $\$18 * 0.6667 = \12) for each target share.
- What if, however, the value of acquirer shares drop after the announcement to \$15 and remain at \$15 until closing date?
- The target would receive 16 million acquirer shares and the deal



value would decline to 16 million * \$15 = \$240 million. Compare that to the original compensation the target expected of \$288 million.

Bottom line: Since the exchange ratio is fixed, the number of shares the acquirer must issue is known, but the dollar value of the deal is uncertain.

REAL WORLD EXAMPLE

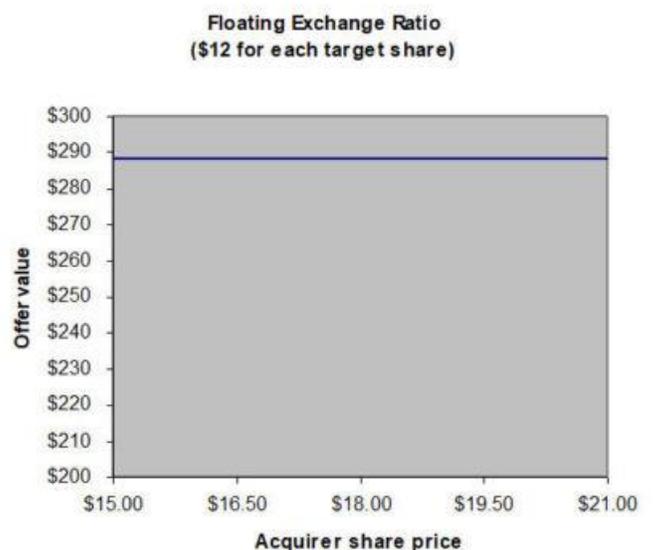
CVS's 2017 acquisition of Aetna was partially funded with acquirer stock using a fixed exchange ratio. Per the [CVS merger announcement press release](#), each AETNA shareholder receives a 0.8378 CVS share in addition to \$145 per share in cash in exchange for one AETNA share.

Floating exchange (fixed value) ratio

While fixed exchange ratios represent the most common exchange structure for larger U.S. deals, smaller deals often employ a floating exchange ratio. Fixed value is based upon a fixed per-share transaction price. Each target share is converted into the number of acquirer shares that are required to equal the predetermined per-target-share price upon closing.

Let's look at the same deal as above, except this time, we'll structure it with a floating exchange ratio:

- Target has 24 million shares outstanding with shares trading at \$12. Acquirer shares are trading at \$18.
- On January 5, 2014 the target agrees to receive \$12 from the acquirer for each of target's 24 million shares (.6667 exchange ratio) upon the completion of the deal, which is expected happen February 5, 2014.



- Just like the previous example, the deal is valued at 24m shares * \$12 per share = \$288 million.
- The difference is that this value will be fixed regardless of what happens to the target or acquirer share prices. Instead, as share prices change, the amount of acquirer shares that will be issued upon closing will also change in order to maintain a fixed deal value.

While the uncertainty in fixed exchange ratio transactions concerns the deal value, the uncertainty in floating exchange ratio transactions concerns the number of shares the acquirer will have to issue.

- So what happens if, after the announcement, the acquirer shares drop to \$15 and remain at \$15 until the closing date?
- In a floating exchange ratio transaction, the deal value is fixed, so the number of shares the acquirer will need to issue remains uncertain until closing.

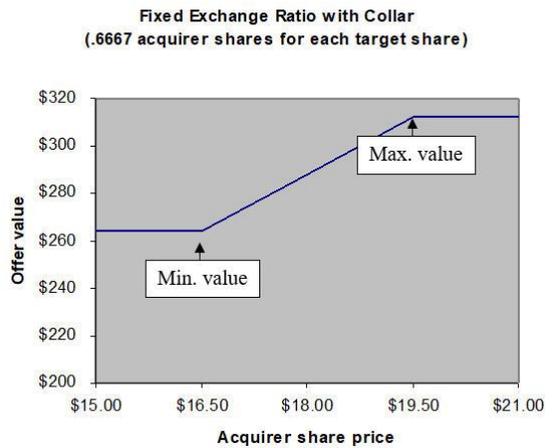
Collars and caps

Collars may be included with either fixed or floating exchange ratios in order to limit potential variability due to changes in acquirer share price.

Fixed exchange ratio collar

Fixed exchange ratio collars set a maximum and minimum value in a fixed exchange ratio transaction:

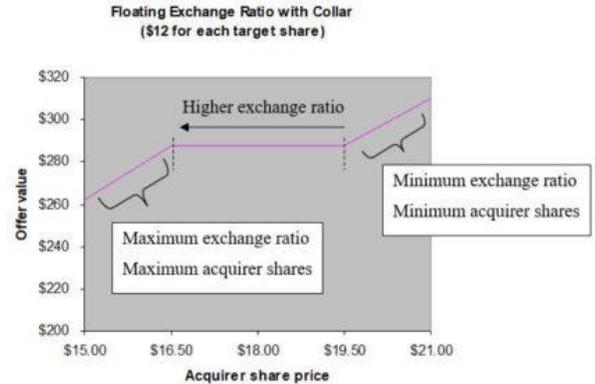
- If acquirer share prices fall or rise beyond a certain point, the transaction switches to a floating exchange ratio.
- Collar establishes the minimum and maximum prices that will be paid per target share.
- Above the maximum target price level, increases in the acquirer share price will result in a decreasing exchange ratio (fewer acquirer shares issued).
- Below the minimum target price level, decreases in the acquirer share price will result in an increasing exchange ratio (more acquirer shares issued).



Floating exchange ratio collar

The floating exchange ratio collar sets a maximum and minimum for numbers of shares issued in a floating exchange ratio transaction:

- If acquirer share prices fall or rise beyond a set point, the transaction switches to a fixed exchange ratio.
- Collar establishes the minimum and maximum exchange ratio that will be issued for a target share.
- Below a certain acquirer share price, exchange ratio stops floating and becomes fixed at a maximum ratio. Now, a decrease in acquirer share price results in a decrease in value of each target share.
- Above a certain acquirer share price, the exchange ratio stops floating and becomes fixed at a minimum ratio. Now, an increase in acquirer share price results in an increase in the value of each target share, but a fixed number of acquirer shares is issued.



Walkaway rights

This is another potential provision in a deal that allows parties to walk away from the transaction if acquirer stock price falls below a certain predetermined minimum trading price.

Earnouts in M&A

How contingent consideration and earnouts are structured in acquisitions

An earnout, formally called a contingent consideration, is a mechanism used in M&A whereby, in addition to an upfront payment, future payments are promised to the seller upon the achievement of specific milestones (i.e. achieving specific EBITDA targets). The purpose of the earnout is to bridge the valuation gap between what a target seeks in total consideration and what a buyer is willing to pay.



This will all be yours. Maybe.

Types of earnouts

Earnouts are payments to the target that are contingent on satisfying post-deal milestones, most commonly the target achieving certain revenue and EBITDA targets. Earnouts can also be structured around the achievement of non-financial milestones such as winning FDA approval or winning new customers.

A 2017 study conducted by SRS Acquiom looked at 795 private-target transactions and observed:

- 64% of deals had earnouts and revenue milestones
- 24% of deals had earnouts had EBITDA or earnings milestones
- 36% of deals had earnouts had some other kind of earnout metric (gross margin, achievement of sales quota, etc.)

Prevalence of earnouts

The prevalence of earnouts also depends on whether the target is private or public. Only 1% of public-target acquisitions include earnouts¹ compared with 14% of private-target acquisitions².

There are two reasons for this:

1. **Information asymmetries are more pronounced when a seller is private.** It is generally more difficult for a public seller to materially misrepresent its business than it is for a private seller because public companies must provide comprehensive financial disclosures as a basic regulatory requirement. This ensures greater controls and transparency. Private companies, particularly those with smaller shareholder bases, can more easily hide information and prolong information asymmetries during the due diligence process. Earnouts can resolve this type of asymmetry between the buyer and seller by reducing the risk for the buyer.
2. **The share price of a public company provides an independent signal for target's future performance.** This sets a floor valuation which in turn narrows the range of realistic possible purchase premiums. This creates a valuation range that is usually far narrower than that observed in private target negotiations.

The prevalence of earnouts also depends on the industry. For example, earnouts were included in **71% of private-target bio pharmaceutical deals** and **68% of medical device deals transactions**². The high usage of earnouts in these two industries is not surprising since the company value can be quite dependent on milestones related to success of trials, FDA approval, etc.

Earnout example

Sanofi's 2011 acquisition of Genzyme illustrates how earnouts can help parties reach agreement on valuation issues. On February 16, 2011, Sanofi announced it would acquire Genzyme. During negotiations, Sanofi was unconvinced of Genzyme's claims that prior production issues around several of its drugs had been fully resolved, and that a new drug in the pipeline was going to be as successful as advertised. Both parties bridged this valuation gap as follows:

- Sanofi would pay \$74 per share in cash at closing
- Sanofi would pay an additional \$14 per share, but only if Genzyme achieved certain regulatory and financial milestones.

In the Genzyme deal announcement press release (filed as an 8K the same day), all the specific milestones required to achieve the earnout were identified and included:

- Approval milestone: \$1 once FDA approved Alemtuzumab on or before March 31, 2014.
- Production milestone: \$1 if at least 79,000 units of Fabrazyme and 734,600 units of Cerezyme were produced on or before December 31, 2011.

Appendices

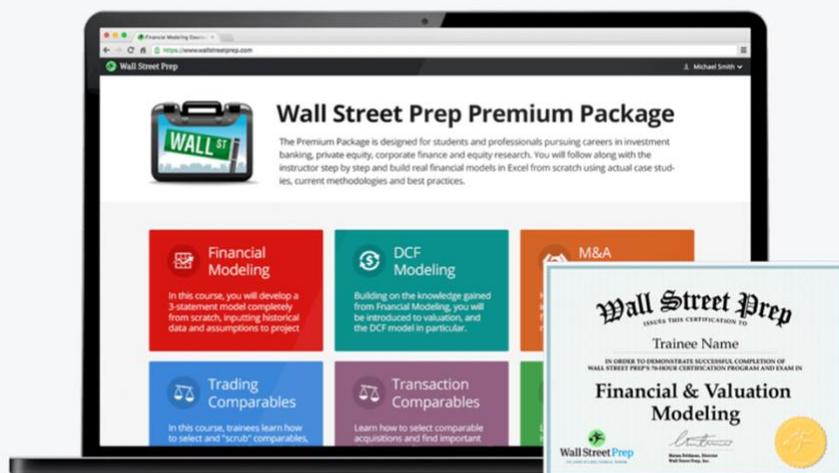
- Sales milestones: The remaining \$12 would be paid out contingent to Genzyme achieving four specific sales milestones for Alemtuzumab (all four are outlined in the press release).

Genzyme did not end up achieving the milestones and sued Sanofi, claiming that as the company's owner, Sanofi didn't do its part to make the milestones achievable.

[Click here](#) to read more about earnouts.

¹ Source: [EPutting your money where your moth is: The Performance of Earnouts in Corporate Acquisitions](#), Brian JM Quinn, University of Cincinnati Law Review

² Source: [SRS Acquiom study](#)



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Sell-Side Process

How M&A sellers prepare for and run a sales process

In M&A, the "sell-side process" describes the deal process from the seller's (and its financial advisors') perspective. There are a variety of reasons why a company might decide to sell:

- **To cash out:** Owners, particularly of private illiquid businesses, often have a significant part of their net worth tied up in the business. An acquisition – either partial or full – is a way to liquidate.
- **There's no clear succession or there are internal disputes:** Owners who are getting older without a clear management succession plan may look to sell, as may owners of a closely held businesses who are in conflict.
- **Strategic rationale:** The business might decide that it's more likely to sustain or grow its competitive advantage if combined with a strategic acquirer. For example, joining forces with a competitor, customer or supplier could help scale, create synergies or open new markets.
- **Distress:** The business might be distressed, facing liquidity problems that it cannot resolve on its own through a financial or operating restructuring.



The sell-side process might begin when an unsolicited buyer approaches the seller or when an owner independently arrives at the decision to sell, but ultimately, the seller has 4 ways it can organize the deal process:

1. Broad auction
2. Limited auction
3. Targeted auction
4. Exclusive negotiation

Broad auction

In a broad auction, the seller's investment banker will reach out to many potential bidders and invite them to participate. A broad auction is designed to maximize the likelihood of receiving bids from multiple parties and to increase the probability of a bid at the highest possible purchase price.

A broad auction is designed to maximize the probability of a bid at the highest possible purchase price.

Advantages of a broad auction

- **It maximizes purchase price:** The primary advantage of a broad auction is that it casts a wide net. More competing bidders = higher maximization of purchase price.
- **It increases the seller's negotiating leverage:** By controlling the bidding timeline and soliciting many bids, the broad auction tilts the information asymmetry in the seller's direction and places the seller in the driver's seat for negotiations.
- **It satisfies the seller's fiduciary responsibility to shareholders:** The broad auction process satisfies owners' fiduciary responsibility to maximize shareholder value. For companies in which the management and board are the primary shareholders (smaller privately held business), this is less of an issue than for companies with a broad shareholders base (common for large public companies.) That said, broad auctions are often not suitable for large public companies because of the limited buyer universe and difficulty of maintaining confidentiality (more on this below).

Disadvantages of a broad auction

- **It makes it difficult to maintain confidentiality:** In a broad auction, the seller must furnish potential buyers with enough information to solicit bids. Even though the seller will demand a confidentiality agreement, private information about the seller's business can leak to competitors. In fact, competitors themselves may participate in the process in bad faith with the goal of gaining access to private information about the seller.
- **It's time consuming and disruptive:** A broad auction presents a larger time and resource drain on the seller than a less formal, more targeted negotiation. More potential bidders means more time the seller must spend marketing and preparing, which can shift management's focus from other primary responsibilities. This is why sellers often find it helpful to retain an investment banker to advise them early on in this process.

Middle market businesses are best suited for a broad auction

Middle market businesses with under \$100 million in equity value are best suited for a broad auction. That's because the buyer pool is smaller for larger companies. Larger sellers tend to be better suited for limited auctions (see below).

Limited auctions

A limited auction is preferable to a broad auction for larger company whose buyer universe is small (i.e. 10-50 potential buyers including both financial and strategic buyers). For obvious reasons, a company with a purchase price of \$500 million will be dealing with a smaller buyer pool than that of a middle market company. For such a large company, a limited auction is the logical choice for running a formal process while containing the disruption of a broad auction and preserving as much confidentiality as possible.

Targeted auctions

In a targeted auction, the seller may reach out to 2 to 5 hand-picked potential buyers. This approach makes sense for larger companies that seek to maintain confidentiality and reduce business disruption while at the same time still retaining a formal process and soliciting enough buyers to meet the seller's fiduciary responsibility to shareholders. For example, in our M&A case study of Microsoft's acquisition of LinkedIn,

LinkedIn, along with investment banker Qatalyst Partners, invited Microsoft, Salesforce, Google, Facebook and another undisclosed party to participate via a targeted auction. A targeted auction made sense for LinkedIn, who realistically has only a handful of potential buyers and for who transaction confidentiality was of utmost importance. Of course, the risk of a targeted auction is that leaving uninvited potential bidders out of the process does not maximize purchase price potential.

A targeted auction makes sense for larger companies that seek to maintain confidentiality and reduce business disruption.

Exclusive negotiation

At the other end of the spectrum from a broad auction is an exclusive negotiation, in which the buyer negotiates exclusively with one partner. The primary advantage is the maintenance of confidentiality, the speed of getting to close and the minimal business disruption. The disadvantages are apparent: One potential buyer means lower negotiating leverage for the seller and an increased probability that value isn't being maximized for shareholders.

Sell side auction timeline

A company's decision to sell is often triggered by an unsolicited approach from a buyer. When that's the case, the seller can either continue to negotiate exclusively with the buyer or attempt to take control of the process by retaining an investment banker and implementing an auction.

When the seller is running an auction process (broad, limited or even targeted), the M&A process is generally broken into four discrete stages:

Sell side auction process and timeline

Preparing for sale: 4-6 weeks

Define Strategy

- Do we want to sell?
- To whom? (Identify potential buyers)
- For how much? (Create a valuation framework)
- What kind of process do we want to run? (Define the process and timetable)

Getting Ready

- Organize financials
- Create projections
- Produce marketing material like the CIM
- Prepare non-disclosure agreement (NDA)

Round 1: 4-6 weeks

- Contact buyers: Exchange NDAs and distribute the CIM
- Receive initial bids: Non-binding indications of interest used to narrow the buyers list

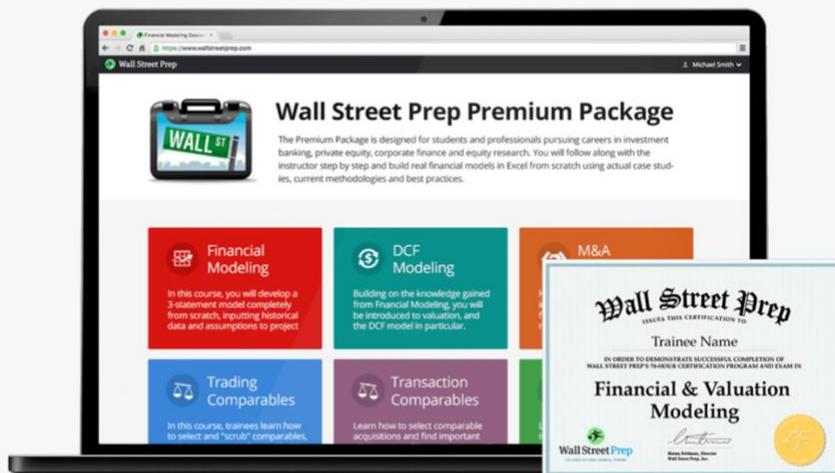
Round 2: 4-6 weeks

- Hold meetings with interested buyers, conduct Q&A and answer follow-ups
- Set up data room and facilitate due diligence for interested acquirors
- Draft definitive agreement
- Receive final bids/letters of intent (LOI)

Negotiations: 6-8 weeks

- Negotiate with buyers submitting bids
- Circulate draft of definitive agreement
- Enter into exclusivity agreement with one bidder
- Continue to facilitate due diligence
- Present finalized deal terms and fairness opinion to seller's board, get board approval
- Sign definitive agreement

Note that in an **exclusive negotiation** the phases are less defined. For example, the seller may not define a clear timetable or distribute a CIM. There might not be a clearly defined Round 1 and Round 2, etc.



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Microsoft – LinkedIn Timeline: An Inside Look at the Merger

who ever thought merger proxies could be so interesting?

M&A transactions can get complicated, with no shortage of legal, tax and accounting issues to sort out. Models are built, due diligence is performed, and fairness opinions are presented to the board.

That said, getting a deal done remains a very human (and therefore entertaining) process. There are some great books that detail the behind-the-scenes-drama of major deals, but you don't have to pull out your Kindle to get the scoop on how things played out for public deals; Much of the negotiation detail is presented in the surprisingly engaging "**background of the merger**" section of the merger proxy.

Below is a behind-the-scenes look at the Microsoft-LinkedIn merger, courtesy of the LinkedIn merger proxy.

Month 1: It begins

It all started on **February 16, 2016**, 4 months prior to the deal announcement, with the first formal discussion between the two companies.

On that day, LinkedIn CEO Jeff Weiner met with Microsoft CEO Satya Nadella to discuss ways to enhance the ongoing commercial relationship between the companies. At the meeting, they discussed how the two companies could work together more closely, and the concept of a business combination was raised. This appears to have started LinkedIn's exploration of a formal sales process.



3 suitors have first dates with LinkedIn in February and March

LinkedIn also began to entertain inquiries from 4 other potential suitors, which the proxy called “Parties, A, B, C and D.” The most serious other bidder was Party A, widely rumored in the press to be Salesforce. Parties B and D were rumored to be Google and Facebook, respectively. Party C remains unknown. To recap:

- **February 16, 2016:** LinkedIn CEO Jeffrey Weiner and Microsoft CEO Satya Nadella discuss a potential merger for the first time.
- **March 10, 2016:** Nearly a month after the Weiner/Nadella discussion, Party A (Salesforce) requests a meeting with Weiner to float the idea of acquiring LinkedIn. Several days later, Weiner meets with Salesforce CEO Marc Benioff about the potential deal. A week later, Benioff tells Weiner that Salesforce has hired a financial advisor to analyze the potential acquisition (turns out it was Goldman, who bet on the wrong horse).
- **March 12, 2016:** LinkedIn’s controlling shareholder Reid Hoffman has a previously scheduled meeting with a senior executive from Party B (Google). After the meeting, the Google executive seeks out separate meetings to be held later in the month with Hoffman and Weiner in order to discuss a potential acquisition.

Month 2: It’s getting real

LinkedIn selects Qatalyst and Wilson Sonsini

- **March 18, 2016:** LinkedIn brings in Wilson Sonsini as legal counsel and chooses Frank Quattrone’s Qatalyst Partners as its investment banker 4 days later. (LinkedIn adds Allen & Co as a secondary advisor a month later.)



*Qatalyst Partners founder
Frank Quattrone*

Qatalyst does its job

- **March 22, 2016:** Qatalyst reaches out to another potential buyer (Party C) to gauge interest. (Party C informs Qatalyst it’s not interested 2 weeks later.)

Facebook dips its toe, but the water’s too cold

- **April 1, 2016:** Hoffman reaches out to Facebook to gauge interest.

- **April 7, 2016:** Facebook bows out. It's officially Salesforce vs Microsoft vs Google!

Month 3: Full-on negotiations

LinkedIn holds due diligence calls

- **April 12, 2016:** LinkedIn management, Sonsini and Qatalyst hold a due diligence call with Salesforce and its advisors. The next day, they have a similar call with Microsoft and its advisors. The day after that, they have a similar call with Google.

Offer price negotiations get real

- **April 25, 2016:** Salesforce submits a non-binding indication of interest of \$160-\$165 per share — a mixed cash stock deal with up to 50% cash — but requests an exclusivity agreement.
- **April 27, 2016:** In light of the Salesforce offer, Qatalyst checks in with Google. Weiner checks in with Microsoft.
- **May 4, 2016:** Google officially bows out. Microsoft submits a non-binding indication of interest at \$160 per share, all cash. Microsoft also says it's willing to consider stock a

Offer price negotiations get real

- **April 25, 2016:** Salesforce submits a non-binding indication of interest of \$160-\$165 per share — a mixed cash stock deal with up to 50% cash — but requests an exclusivity agreement.
- **April 27, 2016:** In light of the Salesforce offer, Qatalyst checks in with Google. Weiner checks in with Microsoft.
- **May 4, 2016:** Google officially bows out. Microsoft submits a non-binding indication of interest at \$160 per share, all cash. Microsoft also says it's willing to consider stock as part of the consideration, and it also wants an exclusivity agreement.



Salesforce CEO Marc Benioff

Over the next several weeks, LinkedIn negotiates with Salesforce and Microsoft, slowly bidding up the price:

- **May 6, 2016:** LinkedIn says it will agree to exclusivity with whichever party agrees to \$200 per share. Neither suitor agrees.
- **May 9, 2016:** Salesforce comes back with \$171, half cash, half stock.
- **May 11, 2016:** Microsoft offers \$172 all cash, but is open to stock if desired by LinkedIn. The same day, LinkedIn and its advisors meet to decide next steps. An interesting point is made: Hoffman prefers a mix of cash and stock in a transaction so the deal can qualify as a tax-free reorganization (enables LinkedIn shareholders to defer taxes on the stock portion of the consideration). Qatalyst goes back to the bidders.
- **May 12, 2016:** Qatalyst reports to LinkedIn that Microsoft and Salesforce are growing tired of the incremental bidding, or, in proxy-speak, Salesforce expects that going forward, "all parties' bids will be considered at once" and Microsoft expresses "a similar concern relating to continued incremental bidding" and seeks "guidance with respect to an acceptable price." LinkedIn holds a meeting and decides to request a "best and final," due the next day. Importantly, it appears that Hoffman favors Microsoft. During the meeting, he tells the LinkedIn Transactions Committee (a committee set up by the board to specifically analyze the deal process) that he wants to let Microsoft know he will support Microsoft as the winning bidder if they offer \$185.
- **May 13, 2016:** Microsoft submits \$182 per share, all cash, with flexibility to include stock if requested. Salesforce also submits \$182 per share, but 50% cash, 50% stock. The stock component has a floating exchange ratio. As we've learned earlier, that means the value of the stock portion of the consideration is fixed (meaning less risk for LinkedIn). Regardless, **LinkedIn chooses Microsoft.**
- **May 14, 2016:** LinkedIn and Microsoft sign a 30-day exclusivity agreement the next day, prohibiting LinkedIn from soliciting other proposals. Broadly speaking, this type of agreement is called a **letter of intent (LOI)**. It formalizes deal discussions and sets a timetable for signing a definitive agreement.

Month 4: Salesforce not out yet

- **For several weeks after exclusivity,** Microsoft ramps up its due diligence. Various merger agreement stipulations between Microsoft and LinkedIn are negotiated. A major negotiation concerns the termination fee. (Microsoft initially sought a \$1B termination fee, which LinkedIn ultimately negotiated down to \$725M).

- **May 20, 2016:** Salesforce revises its offer to \$188 per share with \$85 in cash and the rest in stock. One caveat: Even though the offer is higher, the exchange ratio is fixed in the new offering, meaning LinkedIn takes on the risk that Salesforce's share price will drop between now and closing. While LinkedIn feels the revised offer is essentially equivalent to the prior one, it also has to figure out "the appropriate manner in which to address the revised proposal in light of the LinkedIn Board's fiduciary and contractual obligations." LinkedIn decides it cannot respond to the revised Salesforce offer in light of exclusivity with Microsoft. It defers the issue to a time after Microsoft's exclusivity ends and after Microsoft concludes its due diligence.
- **June 6, 2016:** Salesforce comes back again. Its share price has grown to a point where its fixed-exchange-ratio offer amounts to \$200 per share. LinkedIn decides it will still not respond, but will go back to Microsoft to let them know that as the exclusivity nears, the original \$182 is "no longer supportable." LinkedIn will encourage Microsoft to up the bid to \$200. Hoffman is now OK with all cash.
- **June 7, 2016:** Weiner and Hoffman both separately deliver the bad news to Nadella, who replies that a higher offer will necessitate a discussion of synergies. Translation: If you want us to pay more, you've got to show us where we can trim LinkedIn's costs.
- **June 9, 2016:** LinkedIn CFO Steve Sordello sends Amy Hood, his counterpart at Microsoft, an analysis of potential synergies. Later that day, Microsoft agrees to bump the offer to \$190 per share, all cash.
- **June 10, 2016:** LinkedIn emphasizes to Microsoft the need to go higher, and suggests that a deal will get done at \$196 per share, all cash, contingent on approval by LinkedIn's board.
- **June 11, 2016:** Nadella tells Weiner in the morning that the Microsoft board has agreed to \$196 per share, all cash. Later that morning, legal counsel for both sides button up the negotiations regarding breakup fees and the final version of the merger agreement. Microsoft lawyers had been trying to get Weiner and Hoffman to sign a lockup agreement (legally called a "support agreement") that would contractually obligate them to vote for the deal, protecting Microsoft further from Salesforce. This was refused by LinkedIn. Later in the afternoon, the LinkedIn board meets to decide on the deal. It discusses whether it makes sense to agree to the deal given the breakup fee of \$725 million. It also considers that Salesforce seems willing to keep raising its offer. But this uncertainty is tempered, among other factors, by the fact that Salesforce's offer is contingent on its shareholders' approval while Microsoft's is not. Hoffman indicates that he supports the Microsoft offer and Qatalyst presents its fairness opinion. Finally, the board unanimously approves the transaction.
- **June 13, 2016:** Microsoft and LinkedIn issue a joint press release announcing the deal.

Month 5: Salesforce not out yet. ... again

- **July 7, 2016:** LinkedIn's Transaction Committee meets to discuss the fact that Benioff (Salesforce) sent an email to Hoffman and Weiner after reading the "background of the merger" section of the preliminary merger proxy (filed 3 weeks before the definitive one that this timeline summarizes). Benioff claims that Salesforce would have gone much higher, but LinkedIn hadn't been keeping them in the loop.

Remember, the LinkedIn board has a fiduciary responsibility to its shareholders, so Benioff's email must be taken seriously. During the meeting, the Transaction Committee decides that LinkedIn had in fact done enough to communicate with Salesforce. It does not respond to Benioff's email.

Fairness Opinion: Example and Role in M&A

In the M&A context, a fairness opinion is a document provided by the seller's investment banker to the seller's board of directors attesting to the fairness of a transaction from a financial point of view. The purpose of the fairness opinion is to provide selling shareholders with an objective third-party analysis of the deal's fairness.

This is important because shareholder interests are not always perfectly aligned with the interests of management. Management, for example, may favor one bidder over another (something Salesforce claimed happened when LinkedIn rejected its offer), might be less motivated to conduct a broad auction, or could negotiate terms post-acquisition that favor themselves over shareholders.

The fairness opinion is designed to protect shareholders from the above situations while also protecting seller management teams and boards from shareholder lawsuits upon consummation of the deal.

Example of a fairness opinion

When Microsoft acquired LinkedIn in June 2016, LinkedIn's investment banker, Qatalyst Partners, submitted a fairness opinion to the LinkedIn board as a final step before the board approved the deal.

The representatives of Qatalyst Partners then rendered Qatalyst Partners' oral opinion to the LinkedIn Board, subsequently confirmed by delivery of a written opinion dated June 11, 2016, that, as of June 11, 2016, and based upon and subject to the various assumptions, considerations, limitations and other matters set forth therein, the per share merger consideration to be received ... was fair from a financial point of view.



Appendices

The fairness opinion is included in LinkedIn's merger proxy. It basically states Qatalyst's belief that the deal is fair.

The analysis that supports the fairness opinion is the same analysis that goes into an investment banking pitchbook:

1. DCF valuation
2. Comparable company analysis
3. Comparable transaction analysis
4. LBO analysis

In addition to housing the fairness opinion letter, the LinkedIn merger proxy (like virtually all merger proxies) includes a summary of Qatalyst's valuation methodologies and assumptions as well as the projections (provided by LinkedIn management) Qatalyst used to make the valuation.

Qatalyst's DCF, trading and transaction comps analyses yielded values for LinkedIn ranging from \$110.46 to \$257.96. The actual purchase price was \$196.00. We summarize their valuation conclusions below (quoted text comes from the official LinkedIn merger proxy):

Valuation methodology

Inputs, assumptions and conclusions

<p>DCF</p>	<ul style="list-style-type: none"> • Discount rate: Qatalyst used a range of 10.0-13.0% • Terminal value: Qatalyst used the EBITDA exit multiple method with a multiple range of 12.0x-18.0x. However, Qatalyst changed the definition of EBITDA to “modified EBITDA” to remove non-cash stock based compensation (which is very common), but also removed capitalized software and website costs (which is not at all common, but is defensible as long as the multiples used also reflect this adjustment). • Dilution factor: Qatalyst diluted the cash flow forecast by 12% (after already discounting). This is another Qatalyst innovation ¹ unseen elsewhere and designed to redress the fact that stock based compensation is often ignored in valuation. • Qatalyst’s analysis implies a range of values for the shares of common stock of \$156.43 to \$238.39 per share.
<p>Trading comps</p>	<ul style="list-style-type: none"> • Modified CY17E Modified EBITDA multiples of 4 selected consumer internet companies: "Qatalyst Partners selected a representative range of 12.0x to 18.0x and applied this range to LinkedIn. ... this analysis implied a range of values for the shares of common stock of approximately \$122.35 to \$176.71 per share based on the LinkedIn Projections, and approximately \$110.46 to \$158.89 per share based on the Analyst Projections." ("Analyst Projections" refers to a consensus of third-party research analysts' projections for LinkedIn that Qatalyst utilized.) • CY17E Revenue multiples of 6 selected SaaS companies: "Qatalyst Partners selected a representative range of 4.0x to 7.0x. ... this analysis implied a range of values for the shares of common stock of approximately \$142.17 to \$238.26 per share based on the LinkedIn Projections, and approximately \$137.75 to \$230.58 per share based on the Analyst Projections."
<p>Transaction comps</p>	<ul style="list-style-type: none"> • NTM EBITDA multiples of 11 selected consumer internet transactions: Based on the analysis, "Qatalyst Partners applied an NTM Adjusted EBITDA Multiple range of 17.0x to 27.0x to LinkedIn's estimated next-twelve-months Adjusted EBITDA based on Analyst Projections. ... this analysis implied a range of values for the shares of common stock of approximately \$139.36 to \$213.39." • NTM Revenue multiples of 20 selected SaaS transactions: Based on the analysis, "Qatalyst Partners applied an NTM Revenue Multiple range of 5.0x to 9.0x to LinkedIn's estimated NTM revenue based on Analyst Projections. ... this analysis implied a range of values for the Shares of approximately \$149.41 to \$257.96."

¹ Cynics will argue that Qatalyst’s dilution factor and modified EBITDA “innovations” are [an effort to show a lower valuation](#), thereby making the purchase price offered by Microsoft seem more than fair to LinkedIn’s shareholders. We agree that Qatalyst, like all fairness opinion providers, is incentivized to have the fairness opinion show that the deal is fair (see our discussion on this below). However, notwithstanding the out-of-whack incentives inherent in fairness opinions, both the dilution factor and modified EBITDA methodology are defensible if used consistently. Neither we nor the cynics, however, have access to Qatalyst’s full analysis, which would be required to sort out whether the methodology is actually being used consistently.

Qatalyst’s modification of EBITDA to “modified EBITDA”

Reconciliation of Modified EBITDA to Net Income

The Forecasts include a forecast of LinkedIn’s modified EBITDA. The following table presents a reconciliation of modified EBITDA to net income (loss), the most directly comparable GAAP financial measure. Other than in connection with the preparation of this proxy statement, LinkedIn did not provide Microsoft with this reconciliation.

	2016E	2017E	2018E	2019E	2020E
Net income (loss)	\$ (275)	\$ 44	\$ 303	\$ 565	\$ 831
Add back:					
Provision (benefit) for income taxes	97	24	163	304	447
Other expense, net	58	63	68	65	25
Depreciation and amortization	570	626	621	615	630
Stock-based compensation	581	634	669	687	733
Capitalized software and website costs	(77)	(90)	(96)	(100)	(95)
Modified EBITDA	\$ 954	\$ 1,301	\$ 1,728	\$ 2,136	\$ 2,571

In reality, the fairness opinion is a "rubber stamp"

Despite all the complicated analyses described above, in reality, the fairness opinion is a rubber stamp. Investment bankers are highly incentivized to declare the fairness of a painstakingly negotiated deal. One reason for this is that a large component of an advisor’s success fee is contingent on getting the deal done. Another is the fact that an investment banker’s mandate comes from management, and an I banker that opposes management’s recommendation by declaring a friendly deal unfair will very quickly have trouble finding business. Below, you’ll find the fee structure for Qatalyst’s advisory work for LinkedIn, as disclosed in the LinkedIn merger proxy:

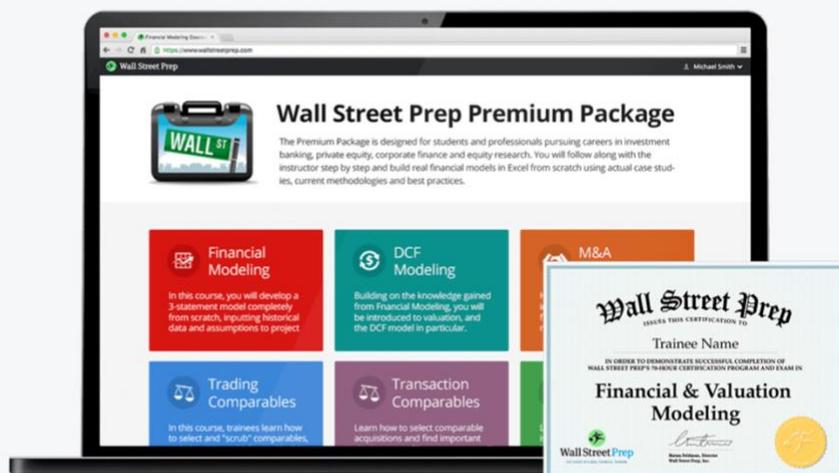
Under the terms of its engagement letter, Qatalyst Partners provided LinkedIn with financial advisory services in connection with a contemplated sale of LinkedIn, which includes the merger, and for which it will be paid approximately \$55 million, \$250,000 of which was payable upon the execution of its engagement letter, \$7.5 million of which became payable upon delivery of its opinion (regardless of the conclusion reached in the opinion), and the remaining portion of which will be paid upon, and subject to, consummation of the merger.

In an attempt to add some integrity to the fairness opinion, some sellers have sought opinions from independent investment banks not providing advisory or financing services to the engagement. While this approach serves to eliminate conflicts of interest, it often doesn't achieve this objective. That’s because the seller is still choosing the fairness opinion provider, and rendering an opinion unfavorable can

It’s no surprise that a fairness opinion in opposition to managements recommendation is essentially unheard of (unless the deal is hostile).

jeopardize that provider's business in the long term. Thus, it's no surprise that a fairness opinion in opposition to management's recommendation is essentially unheard of (unless the deal is hostile).

Most stakeholders in the M&A process are quite aware of this dynamic. Valuation is so dependent on assumptions that a negotiated sale by two willing parties is always justifiable if that's the desired goal. Nonetheless, the obvious conflict of interest has drawn criticism. The fairness opinion, as well as the valuation work that investment banks generally provide to their clients through pitchbooks and CIMs, is widely recognized to differ in motivation, purpose and incentive as compared to that on the buy side.



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Demystifying the Due Diligence Process in Mergers and Acquisitions

Introduction to Due Diligence

There is massive information asymmetry between the buyer and seller when acquiring a company: The seller knows everything about its own business and the buyer knows far less. Making matters worse, the seller is incentivized to hide or downplay negative aspects of the business and exaggerate the positives.



People in the know call due diligence "due dili," As in, "I'm only 180 hours of due dili away from some sleep."

Due diligence is the process by which the buyer solicits information that reduces this asymmetry. Broadly speaking, the due diligence process seeks to aid the buyer in determining whether it wants to proceed with an acquisition, and at what price.

Due diligence overview

Naturally, due diligence is primarily done by the buyer on the seller. However, the seller also performs due diligence on the buyer when buyer stock is used as part of the merger consideration. That's because the seller will now have an interest in the buyer's business. Sellers may also perform some basic due diligence in a cash sale to ensure buyer will be able to finance the acquisition.

Due diligence is unique to each transaction, but a thorough due diligence process usually involves:

Financial due diligence

Historical financial performance (usually the last 3 years)

- Revenue analysis: Customers, products, distribution channels, geography, pricing strategy, key contracts, etc.
- Expenses: Analysis of cost of sales, SG&A, R&D, corporate overhead, key suppliers
- Analysis of company's assets and liabilities including leases, plants and real estate assets
- Analysis of company cash flows

Seller assumptions and projections (quarterly over next 3 years)

- Review and sensitivity of key assumptions on income statement, balance sheet and cash flow statement

Business due diligence

- Analysis of seller's industry, competitive position, strategic plan
- Analysis of key customers and affiliates
- Review of company products, product sourcing strategy and suppliers
- Review of company's research and development and marketing and sales programs
- Compensation of management and key employees
- Ownership: Analysis of key shareholders

Legal, accounting and tax due diligence

1. Legal: Review of IP, patents, outstanding or potential litigation, incorporation documents, employment contracts, key customer and supplier contracts and loan agreements
2. Accounting: Understanding seller's accounting policies, controls and cash management
3. Tax: Review of tax attributes (like NOLs) that may be inherited or lost in an acquisition

Integration and operational due diligence

1. Analysis of synergies and integration planning
2. Cultural fit, retention and compensation of management and employees and location of offices
3. Impact of acquisition on customers, partnerships and suppliers (i.e. channel conflicts, change of control issues)
4. Treatment of options and other dilutive securities, capitalization table
5. Visits to seller's headquarters and facilities
6. Meetings and discussions with seller's management, shareholders and other key stakeholders

Due diligence: public vs private sellers

When the seller is a public company, the diligence can be thought of as a two-phase process:

1. The buyer can conduct a primary diligence process (sometimes before even engaging with the seller) by using public filings (10Ks and 10Qs, proxy statements) to learn about the sellers financials, operations, and shareholders.
2. Private information is shared. This is provided by the seller once the buyer and seller sign a confidentiality agreement (CA), also called a non-disclosure agreement (NDA).

When the seller is a private company, there's very little due diligence that can be performed (beyond perhaps a sector or industry analysis) until the seller willingly provides nonpublic information. Comprehensive due diligence can only begin once the CA is signed.

Due diligence process: how information is gathered

When sellers run a formal auction, the due diligence process will usually look something like this:

1. The seller (or the seller's banker) will reach out to several potential buyers to gauge interest in an acquisition. (When the seller reaches out to a small predefined group of potential buyers it's called a "targeted auction.")
2. For acquirers that choose to engage in the process, an NDA is negotiated and the seller distributes a confidential information memorandum (CIM), also called an offering memorandum (OM). This

document contains nonpublic information about the seller, and helps the buyer perform preliminary due diligence.

3. A buyer interested in bidding during this first round will sometimes (but not always) be asked to submit an **expression of interest (EOI)**, which usually contains a purchase price range. At this point, the second round, with a narrowed buyer universe, begins. Interested buyers hold followup meetings and discussions with seller management. A Q&A period begins.
4. Often, the buyer and its advisors conduct physical visits to the seller's headquarters, facilities and plants.
5. The EOI should not to be confused with the more formal letter of intent (LOI). There's a point in the process when the seller hopes to receive an LOI from the narrowed potential buyers list. The LOI is either a binding or non-binding agreement that gives more specifics on agreement terms including a specific purchase price and form of consideration. When one or more LOI is received, the buyer will request (and the seller will provide) further details and sensitive private information via a document management system called a virtual data room. The junior banker's role in this process is to manage the data room. He or she will coordinate with lawyers, accountants and management teams to ensure that all requested seller documents are provided and entered into this central repository.
6. Interviews with suppliers and customers are typically allowed by the seller on a limited basis after an LOI has been received.

Learn more about M&A

- [The complete guide to M&A](#)
- [Sell side process](#)
- [Accretion dilution analysis](#)
- [Sample letter of intent \(LOI\)](#)
- [Sample M&A pitchbook](#)