Structuring and Valuing Transactions

Doing the deal

Agenda

Day 1
- Primary financial instruments
- Structuring transactions – objectives
- Quasi-equity instruments
- Valuation basics
- ZHL Case
  - Valuation by discounting free cash flows (breakout groups)
  - Discussion on valuation and structure for ZHL

Types of financial instruments
Building Blocks of a Financial Instrument

1. Risk
2. Yield
3. Upside

Risk

- Risk is a function of variability of expected returns and time frame expected for making such returns.
- The higher the risk of the underlying project, the higher the return you would require as an investor.
- Risk is determined by among other factors:
  - The stage of the business – start-up, seed capital, venture, growth, mature.
  - The product/service market, regulatory environment, other extraneous risks (eg environmental risk).
  - Off-take agreements.
  - Track record, technical expertise and market networks of business developers/project sponsors.

Risk can be managed down by:

- Giving the investor a way out i.e. redeemability.
- Providing security.
- Providing a third party guarantee.
- Entering into covenants.
- Giving veto rights.
- Giving additional voting rights in certain circumstances.
Yield

- Any payment made to the investor during the period for which the investment is outstanding, other than payments which reduce capital
- Can be regular or irregular
- Set amount or at the discretion of the paying company
- Often linked to an underlying reference point

Upside

- Arises from selling a security for a higher amount than was originally invested in it – capital gain
- Upside arises from:
  - Sale to another investor
  - Redemption at a premium
    - In cash or securities of the investee companies
    - In the securities of another company or in another asset

The debt-equity continuum of financial products

![Graph showing the debt-equity continuum with perceived risk on the x-axis and required return on the y-axis, illustrating the relationship between perceived risk and required return for secured debt, ordinary shares, and other financial products.]
# Debt & equity

<table>
<thead>
<tr>
<th></th>
<th>Debt</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk to investor</td>
<td>Low, protected by security and covenants</td>
<td>High</td>
</tr>
<tr>
<td>Yield</td>
<td>Interest, normally contractually agreed</td>
<td>Dividends, at the discretion of the directors</td>
</tr>
<tr>
<td>Potential upside to the investor</td>
<td>None</td>
<td>Very high</td>
</tr>
</tbody>
</table>

## Debt

**Pros**
- Leverage can engineer higher returns - equity realises large gains as the debt is paid down
- Interest is tax-deductible
- No dilution of current shareholders. In MBOs, debt lowers the equity portion of the financing of a deal to levels at which executives can afford
- Financial discipline instilled by debt-holders reporting and ratio requirements compels managers to improve performance and carefully manage cash flows

**Cons**
- Adds risk
- Extremely unforgiving to weak financial structure, poor business judgement or bad management
- Adversely amplifies the impact of environmental factors such as market dislocations and socio-political threats

## Equity

**Pros**
- Equity partners are motivated to provide more than just money
- Stringent debt/equity ratio requirements may limit borrowing capacity so additional debt may not be an option

**Cons**
- It is an expensive and time-consuming process to raise equity
- Early stage companies give away too much value by bringing in equity, but they may have no other option
The Debt-Equity Continuum

Quasi-Equity Instruments

- **Subordinated debt** – the simplest form of quasi-equity. It is unsecured debt or debt which is junior to secured debt.
- **Mezzanine debt** – Mezz is any debt that is between the equity and senior (secured) debt – including subordinated debt. Mezz typically has a high yield and may have other features such as warrants or convertibility attached.
- **Revenue/profit participation** – An income note or other redeemable instrument that attracts a return linked to the revenue or profit performance of the investee.
- **Convertible debt** – debt that is redeemable or convertible into ordinary or preference shares.
- **Preference shares** – Share capital that attracts a fixed coupon return. The preference shares may be redeemable or non-redeemable, and the coupon rate payable on the shares may be cumulative or non-cumulative.

References for this section

Structuring Transactions: The Aim

The aim of structuring a transaction is to optimise and align the interests of all participants.

Considerations in structuring could include:
- Matching finance and underlying project/business cash flows timing
- Exit considerations
- Incentives to specific participants in the transaction eg management in a management buy-out
- Tax efficiency
- Optimising the financial structure to get to the ideal risk/return profile
- Minimising transaction costs

Questions to Answer in Structuring

- How much funding is needed?
- What is the investment horizon and how will we exit?
- What term structure is appropriate?
- What are the instruments available?
- What structure can the business support?
- What is needed in the structure to align the interests of the key parties?
How Much Funding is Needed?

The funding needed comprises primarily of:
1. Company valuation – what the business is worth
2. Refinancing existing debt
3. Working capital requirements
4. Funding for growth – split between retained earnings and external sources
5. Transaction costs – cost of raising finance, legal fees, accountants, external operational expertise

Exits

- Trade sale
- Exit to larger or later stage PE investor
- Buy-backs, put option to sponsors
- MBO/MBI
- Redeemable instruments
- IPO

Impact of exit risk on structuring

- Exit is a major issue in developing economies
- Generally, investors like some form of redeemability in the structure of investments in developing economies
- BUT, to capture some of the upside, they would introduce “equity kickers” in the structure
Tax Deductibility of Interest

- In most countries of the world, interest is tax deductible, whereas dividends are not
- This adds to the attractiveness of debt to project sponsors

What do investors add?

- Business networks and track record
- Access to expertise, skilled labour, debt
- Corporate governance
- Operational and financial discipline
- Ready access to additional finance for future growth

Sustainable Level of Debt

The debt a business can sustain is determined by:

- Gearing/leverage (debt/equity or debt/capital employed)
- Interest cover (EBIT or EBITDA divided by interest payable) or cash interest cover (denominator is cash interest payable)
- Debt service coverage ratios (denominator includes both interest and principal repayable)
- Security available
- Liquidity or separability of securable assets
- Reputation/track record of the borrowing party
Quasi-Equity

- There are instances where debt may be too onerous (e.g., portion of secured debt available, based on asset value and track record, is not sufficient for the project) and additional equity is just not possible.
- The solution is to get debt with some equity features which improve the yield and make the opportunity attractive to investors.

Quasi-Equity: Subordinated & Mezz Debt

- The business is cash-flow positive and can sustain (cash or cumulative) interest payments.
- Senior debt or asset finance capacity is constrained, yet the business could benefit from additional leverage.
- Dilution or ownership/control is major concern.
- Finance (often bridging finance) is needed to unlock an opportunity, but equity raising would take too long or is too expensive at the early stage.

Quasi-Equity: Revenue/Profit Participation

- The business is expected to grow substantially on the back of the quasi-equity provided, and traditional fixed or variable interest rate structures are inadequate to address the risk borne by the incoming investors.
- Debt service cover is highly dependent on revenue or profit growth.
- Senior debt or asset finance capacity is constrained, yet the business could benefit from additional leverage.
- Dilution or ownership control is major concern.
### Quasi-Equity: Convertible Debt

- The business is cash-flow positive and can sustain (cash or cumulative) interest payments.
- Investors are concerned about high risk at the early stages of the business, and therefore want redeemability of their stake. In the meantime, they take a “wait and see” attitude.
- Dilution today would be too expensive, but the impact can be softened by deferring equity participation to a later date.
- Senior debt or asset finance capacity is constrained, yet the business could benefit from additional leverage.

---

### Quasi-Equity: Preference Shares

- Pref can be
  - redeemable/non-redeemable
  - cumulative/non-cumulative
  - convertible/non-convertible
  - voting/non-voting
- Pref are generally quite expensive, because they do not enjoy tax-deductibility of interest but are widely used in the VC industry.
- Pref are be attractive where they are treated as permanent equity (eg where a sinking fund is required to replace redeemed prefs with equity) giving comfort to senior lenders and/or regulators.
ZHL in India

- Provider of ambulance service in India
- Target market: Low to middle income
- Annual revenues of $9.1M and EBITA of ($2.9M)
- Has requested an equity investment of $1,500,000
- Purpose of financing is to expand ambulance service

What are the Sources and Uses of Funds?

<table>
<thead>
<tr>
<th>Uses of Funds (USD)</th>
<th>Sources of Funds (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CapEx</td>
<td>Equity 1,290,000</td>
</tr>
<tr>
<td>Marketing Launch</td>
<td>Equity 1,500,000</td>
</tr>
<tr>
<td>Working Capital</td>
<td>Equity 50,000</td>
</tr>
<tr>
<td>Total Uses</td>
<td>Total Sources 1,300,000</td>
</tr>
</tbody>
</table>

What was the actual deal structure?

- Common equity?
- Preferred shares?
  - 7.5% cumulative dividend
  - Convertible into common equity
  - Not redeemable before 5 years from date of issue
  - Liquidation preference: above common equity but below debt
- Something else?

What determines which instrument is most desirable?

By the way, was the valuation of ZHL stated?
Enterprise Valuation – The Basics

- **Objective of valuation**
  - Determines price investor must pay for equity
  - Based on due diligence and resulting financial projections
  - Pre- and post-money valuations

- **Valuation is subjective**
  - Different investment objectives, synergies & risk profiles
  - Investors are people and people are subjective!

- **Valuation methods**
  - Book value/net asset method
  - Comparable sales (sales/profitability multiples method)
  - Internal rate of return (IRR) method
  - Discounted cash flow (DCF) method

Valuations - Sales/EBITDA Multiples

- **Sales/EBITDA Multiples**
  - ‘Pre-money’ valuation based on sales/EBITDA multiple (1x sales or 4x EBITDA)
  - Multiples often used for preliminary value to screen deals or estimate value
  - In developing markets, developed market multiples can be used by “discounting” for illiquidity, political risk, etc.
  - When available, multiples from recent comparable sales can be used
  - Multiples also used in conjunction with other valuation methods

Valuations – Internal Rate of Return (IRR)

- **Internal Rate of Return (IRR)**
  - Projected investor returns satisfies a target internal rate of return from projected cash flows
  - Target IRR can be tiered according to established risk levels
  - Use projected cash flows of company or your investment?
Valuations – Discounting Free Cash Flows

Discounting Free Cash Flows (FCF)

- Perhaps most common of valuation methods
- Present Value of Projected Annual Free Cash Flows less Debt

- Free Cash Flows: Revenues
  - Operating costs
  - Taxes
  - Net investment
  - Change in non-cash working capital
- Free Cash Flow

- Discount Rate is Company’s ‘Cost of Capital’

Valuations – Illustrative DFCF Example

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Terminal Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>500,000</td>
<td>750,000</td>
<td>1,000,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Less: Operating costs</td>
<td>300,000</td>
<td>450,000</td>
<td>650,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Non-cash WC change</td>
<td>50,000</td>
<td>100,000</td>
<td>150,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>30,000</td>
<td>50,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Net investment</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Free Cash Flow</td>
<td>20,000</td>
<td>50,000</td>
<td>20,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Disc. FCF</td>
<td>17,544</td>
<td>38,473</td>
<td>13,499</td>
<td>41,446</td>
</tr>
</tbody>
</table>
| Sum of DFCF less debt = Valuation = $334,828

Valuations – Illustrative DFCF Example

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Terminal Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>500,000</td>
<td>750,000</td>
<td>1,000,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Less: Operating costs</td>
<td>300,000</td>
<td>450,000</td>
<td>650,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Non-cash WC change</td>
<td>50,000</td>
<td>100,000</td>
<td>150,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>30,000</td>
<td>50,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Net investment</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Free Cash Flow</td>
<td>20,000</td>
<td>50,000</td>
<td>20,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Disc. FCF</td>
<td>17,544</td>
<td>38,473</td>
<td>13,499</td>
<td>41,446</td>
</tr>
</tbody>
</table>

Formula: $\text{PV} = \frac{\text{FCF}}{(1+r)^1} + \frac{\text{FCF}}{(1+r)^2} + \frac{\text{FCF}}{(1+r)^3} + \frac{\text{FCF}}{(1+r)^4}$

Sum of DFCF less debt = Valuation = $334,828
Valuation: ZHL Case Study

Objective: Determine your ZHL valuation by DFCF

- Four groups (2 in main room, 1 in side room & 1 on terrace)
- Roles:
  - 1 Facilitator/Decision maker
  - 1 Excel "maestro"
  - 2 Fact finders
  - 1 Presenter back to main group
- Use Free Cash Flow model as your guide for ZHL
- Try to have all in group understand how valuation determined
- Take 60 minutes!
- Report back on (1) valuation, (2) key revenue drivers, (3) excel sheet model and (4) key choices or differences of opinions

Valuation – ZHL Case Study

<table>
<thead>
<tr>
<th>Revenues (in 000s)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Terminal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td># of ambulances</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in WIC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free Cash Flow</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disc. FCF</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Valuation = 85,402,000 rupees = $3,332,000

What would be "pre-money" valuation?
Tools to Further Align Interests

Instruments to align interests & bridge gaps

- Options and warrants
- Ratchets
- Earn-Outs

Options and Warrants

- Options – contract that allow you to purchase or sell a security at a particular price.
- Warrants – options that allow you to purchase ordinary shares at a specified price.

Options and warrants are useful in structuring sweeteners to uplift debt and quasi-equity returns, and also aid in structuring earn outs and ratchets used to resolve differences in perception of future prospects.
Earn-Outs

An Earn-Out is a structure where part of the acquisition price is payable in future based on achievement of target levels of results (eg revenue or profits).

- The earn-out structure is particularly attractive in high-growth early stage ventures where:
  - a substantial portion of the value will be achieved in the future; and
  - this value creation will be achieved by the vendor team as part-owners of the business, with funding from the incoming investors.

Structuring an Earn-Out

- Up-front payment (upto 70% of perceived value) This comprises of:
  1. Ongoing operational cost of the company, or cash-burn since inception to date of acquisition +
  2. Partial up-front payment of perceived value
- Subsequent milestone payments, comprising the remainder of value, typically based on a multiple of incremental revenue generated. This is often structured as a put option (where vendors can “put” their shares to acquirers based on a pre-determined pricing formula)
- Some earn-out structures cap the total payment or alternatively, set a time limit for payments

Ratchets

Equity ratchets are financial structures where management’s percentage of equity in an MBO is adjustable depending on measures of performance.

- Often deployed in MBOs to incentivise management and/or resolve differences in perception of prospects
- Performance measures used could be financial or non-financial (eg achieving an IPO)
- While ratchets may resolve differences in perception of future prospects at the time of acquisition, they could cause conflict in future
Structuring Ratchets

- Positive ratchets start management at low percentages of equity, which increases if they achieve pre-set performance measures.
- Negative ratchets start with management at a high equity percentage, some of which they have to forfeit if targets are not achieved.
- Ratchets are based on:
  - Convertible debt instruments, with conversion terms depending on performance measures; or
  - Put/call options on ordinary shares – ability to exercise and/or exercise price depends on performance measures.

Good Ratchet Design

- Must take into account the cash flow needs and means of the company, investors and management.
- Human psychology suggests that positive ratchets would be better than negative ratchets.
- Clarity and robustness of performance measures (revenue better than profit, multiple year measures better than single).
- Tax considerations.

Tax Issues

- Compensating tax – while structuring may save some tax, it could catch up with us through the compensating tax structure.
- Thin capitalisation – if the company is deemed to be thinly capitalized, some of the interest expenses and exchange losses will not be tax deductible in many jurisdictions.
- Management fees:
  - Management fees is sometimes used to take out some of the return to a tax haven.
  - Tax authorities in most countries are aggressively trying to curb transfer pricing.
What is a Term Sheet

The Term Sheet is a document that outlines the material terms and conditions of a business agreement.

- Often in bullet point form
- Non-binding (except for certain provisions), even though it may be “executed” or signed
- Meant as a guide to legal counsel to prepare the final transaction documents
- Mutual clarity and understanding at term sheet stage can save a lot of trouble in final negotiations and agreement execution.
Typical Contents of a Term Sheet

- Price and investment structure – split between various instruments and terms (price, interest rate, tenor, repayment, convertibility etc) of each
- Conditions precedent and representations & warranties
- Protective provisions – minority protections, drag-along rights, anti-dilution, step-in clause, pre-emption rights etc
- Corporate governance structures – board structure, voting rights, vetoes and reserved matters etc
- Information and access rights
- Governing law and mechanisms for conflict resolution
- Exclusivity, confidentiality and any other terms and conditions that are material to the transaction

Preamble

This Term Sheet is intended solely as a basis for further discussion and is not intended to be and does not constitute a legally binding obligation by PE Fund Limited.

Certain provisions may be specifically binding:
- Confidentiality
- Exclusivity and break-up fees
- Any other fees or expenses payable upfront
- Governing law

Investment Instrument and Price

- Identify the investment vehicle (company or SPV)
- What instruments are you investing in and at what price. If appropriate, what % stake are you getting
- Be clear what the pre-money and post-money valuations are so there is no confusion
- Ensure that any impact of existing dilutive instruments, such as outstanding warrants, employee stock options are taken into consideration in determining pre-money shares outstanding

Valuation is temporary, control can be forever
Conditions Precedent

Term sheets usually emphasise the terms are subject to:
- Satisfactory conclusion of due diligence
- Business plan and budgets provided and agreed
- Employment contracts executed, especially important in MBOs and cases where vendors are still with the company after transaction
- Satisfactory execution of transaction documents

Reps & Warranties

- Reps & warranties are statements by which one party gives certain statements of fact (representations) and assurances (warranties) to the other, and on which the other party may rely
- These are usually covered in the detailed agreements but some basics may be included in term sheets, to give incoming investors some assurance that there is a due diligence-able transaction.
- In Agreements, there may be remedies specified for breach of reps and warranties, but inclusion in term sheets is meant more for mutual clarity of critical underlying facts.

Protective Provisions - General

For as long as Investor holds at least x% of the ordinary shares of Company ABC, its consent will be required for any action relating to:
- Changes in the rights and privileges of shareholders
- Increase/decrease in the number of shares
- Mergers, acquisitions, corporate reorganizations
- Dividends
- Changes in number of Board seats
- Changes in company charter (mem & arts)
- Debt issue in excess of $x
Pre-emptive Rights

- Pre-emptive rights: Shares must be offered to existing shareholders first before they are made available to any external parties.
- Right of First Refusal: Pre-emptive rights are usually structured as rights of first refusal on a pro-rata basis. Rights of first refusal could be structured to allow first refusal to more than a pro-rata allocation of shares.
- Right of First Offer: Weaker than right of first refusal. It is merely an agreement to negotiate in good faith first with the right holder before negotiating with others.

Antidilution

- Pre-emptive rights provide some protection against dilution in offer of new ordinary shares (or other share securities), provided investors inject cash. Stronger antidilution measures could include the following, in the event new shares are issued at a price lower than price paid for existing shares:
  - Full ratchet – there is an automatic pro-rata adjustment of number of old shares to reflect new price
  - Weighted average – adjustment is made on a weighted average basis
- These antidilution measures are particularly useful in dealing with convertible instruments (e.g., convertible debt or prefs).

Impact of antidilution

Investor bought 20% stake in $100,000 company at $1.00 per share. Investor has 20,000 shares. Suppose in a subsequent “down round” of financing, which Investor is not participating in, additional $100,000 is raised by issuing 125,000 new shares at $0.80 per share:

<table>
<thead>
<tr>
<th></th>
<th>No Adjustment</th>
<th>Full Ratchet</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original shares held</td>
<td>20,000</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Antidilution adjustment</td>
<td></td>
<td>2,500</td>
<td>2,500</td>
</tr>
<tr>
<td>Final number of shares held</td>
<td>22,500</td>
<td>22,500</td>
<td>22,500</td>
</tr>
<tr>
<td>Final value per share</td>
<td>0.80</td>
<td>0.80</td>
<td>0.80</td>
</tr>
<tr>
<td>Final value of investor stake</td>
<td>18,000</td>
<td>20,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Original % stake</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>New % stake</td>
<td>11%</td>
<td>11%</td>
<td>10%</td>
</tr>
</tbody>
</table>
Tags & Drags

- Tag Along Rights – The Founders/Sponsors may not sell, transfer or exchange their stock unless each investor has an opportunity to participate in the sale on a pro-rata basis. Sometimes also referred to as co-sale rights.
- Drag Along Rights – The Founders/Sponsors and other shareholders may be forced to participate in a sale alongside the PE/VC if an attractive offer is accepted by the PE/VC. This right is often subject to majority vote (useful only if the Founders/Sponsors are not majority) and sometimes subject to failure of Founders/Sponsors to achieve certain mutually agreed milestones.

Step-in Clause

- This clause gives the PE/VC Investor the right to essentially take over the company in the event of a major default or failure to meet pre-agreed targets by the investee shareholders/management.

Corporate Governance

- Voting rights & reserved matters – PE/VC Investors often reserve critical matters (borrowing, appointment of CFO/CEO etc.) These can be handled by requiring Board member representing the PE’s vote, or the PE shareholder’s vote (which would have to be done through a shareholders agreement). PE’s may require this even if they are holders of prefs and not ordinary shares.
- Board seat numbers are specified, with PE/VC having representation.
Information/Access Rights

- Specify regular provision of budgets, management accounts, audited financial statements and other critical operating information
- Specify access and visitation rights
- These provisions are difficult to enforce in practice if an investee refuses to play ball, but it is important to communicate clearly upfront the basic minimum information you desire.

Governing Law

- In cross-border deals, a neutral and respected jurisdiction is preferred. Laws of England are widely used in Commonwealth countries.
- Arbitration clause is important because traditional legal remedies generally take too long in emerging economies.

Exclusivity, Confidentiality & Fees

- Generally better to include these in a covering “Mandate Letter” which is a contract, with the term sheet being a non-binding annex to the Mandate Letter.
- Exclusivity/No Shop: Specifies a timeframe within which the transaction shall be exclusive to PE.
- Confidentiality: Usually better dealt with in an independent Non-Disclosure Agreement
- Fees – Some PEs might require fees for due diligence. Generally, legal fees are paid by Newco or Investee Company.
Investment reports

- Target audience – the Investment Committee
- Preliminary report
  - Focus should be on providing preliminary information on the opportunity and its merits
- Final report
  - Focus should be on specific issues or questions raised by the Investment Committee at the preliminary stage
  - It should also document the due diligence findings
  - Ideal size – 30 pages. If more detail is required, include as an annexure, with a summary in the main report

Preliminary investment report

- Executive summary
- Business overview
  - History
  - Nature of the business
  - Customers
  - Raw materials
  - Technology
- Industry overview
  - Competition
  - Raw materials supplies
  - Technology
Preliminary investment report.../2

- Management
  - Management team
  - Management investment
  - Management gearing
- Proposed transaction
  - Transaction structure
  - Pricing and expected returns
- Projected financial performance
  - Normalised historical performance
  - Base case forecasts
- Due diligence

Preliminary investment report.../3

- Investment evaluation
  - Points for the proposal
  - Points against the proposal
  - Conclusion
- Annexes
  - Base case financial model
  - Historical financial results and normalisation adjustments

Final investment report

- Introduction
- Issues raised at the preliminary assessment
- Business and market overview summary
- Historical and forecast financial performance
- Year to date performance
- Due diligence
- Investment evaluation
- Conclusion
- Annexes
  - Detailed and market overview
  - Management overview
  - Financial analysis, pricing and expected returns
  - Base case financial model
Introduction

- A substantial part of the contents of corporate finance documents is “boilerplate” (standardised).
- After a few deals and recognising documentation similarities across transactions, one may be tempted to generate their own documentation for further deals – it will not save you legal expenses.
- The value of a lawyer is in:
  - Nailing down the details of an agreement
  - Providing for exceptions
  - Identifying and allocating risks

But we need to understand a good legal documentation process in order to draft sensible heads of terms and review legal agreements for assurance that they achieve what we intend.

Good sale documentation

- Sets out in unequivocal terms the full scope of the agreement between parties – contracts should be drawn up as between strangers.
- Structure:
  - Contents page (if long)
  - Parties to the agreement
  - Recitals – statements of fact that set the scene (“whereas….”)
  - Exact terms of the agreement (“Now it is hereby agreed…” or “the parties agree as follows”)
  - Definitions
  - Pre-conditions or conditions precedent
  - Covenants
    - Obligations of the seller (positive and negative)
    - Restrictive covenants
    - Purchaser’s covenants
Good sale documentation...

- Structure (...cont’d):
  - Completion matters
  - Representations and warranties and indemnities
  - Variation of the contract
  - Waiver of rights
  - Notices
  - Governing law
  - Signing and witnessing

Representations and warranties

- A representation
  - A statement by a party to a contract about a specific fact that is correct or true as at a particular time which must be in the past or present but not in the future
- A warranty
  - A guarantee that a given fact will exist or be true at some future time
- Representations and warranties set out in the contract the factual basis under which each of the parties enters the contract and allocates risks between them
- Although the buyer’s due diligence should provide it with a high level of comfort, representations and warranties are required as it will be impossible in the short time available to track down and evaluate all material risks

Representations and warranties...

- Typical representations and warranties:
  - The seller owns the assets of the business or shares of the company to be sold
  - The company to be sold has good title to its assets
  - All material liabilities have been disclosed and there are no undisclosed contingent liabilities or pending litigation against the company
  - The financial information provided correctly reflects the affairs of the business
  - There have been no untoward financial or other events in the intervening period since the accounts were last published
  - All material contracts have been disclosed, especially those in the normal course of business
Representations and warranties.../3

- Typical representations and warranties (...cont’d):
  - Various representations regarding employees
  - The company has complied with all governmental and regulatory requirements, licences and approvals
  - All tax and VAT returns have been duly completed and filed and no disputes are pending

Indemnities

- An indemnity
  - An undertaking given by one party to another to compensate the latter for loss or damage arising from a misrepresentation, a breach of warranty or the occurrence of an event
  - Example: if a target company is likely to be sued, the buyer would seek an indemnity to cover the costs of the lawsuit and damages that may have to be paid if the case is lost
  - The indemnified party should thereby be restored to the financial position that existed before the loss

Indemnities.../2

- Reducing the seller’s exposure under warranties and indemnities
  - Limiting the scope of the representations and warranties
  - Aggressive disclosure
  - Placing a ‘cap’ on its potential liability in the event of a breach
  - Excluding de minimis claims
  - Limiting the representations and warranties as to time
  - Reserving the right to receive full information on a claim and to pursue mitigating measures
  - Restricting (in the case of representations) the buyer’s remedies to monetary damages
  - Excluding amounts recovered by the buyer (or the company) from third parties (e.g. through an insurance policy)
Reducing the seller's exposure under warranties and indemnities (cont'd)

- Agreeing that the buyer should exhaust all other avenues before claiming under the representations and warranties and that amounts received there from (e.g., insurance) are set off against a claim against the seller.

Indemnity vs. guarantee

- Guarantee is not a stand-alone obligation but supports a primary liability between contracting parties which do not include the guarantor.
- An indemnity is a primary liability to indemnify a contracting party irrespective of whether or not a contracting party is at fault.

Indemnity vs. warranty

- Warranties:
  - are for potential risks – matters that are of particular concern to the buyer;
  - a breach of a warranty will entitle a buyer to claim damages from a seller if he can show that the breach has reduced the value of the asset purchased.

Indemnities

- are for specified liabilities:
  - entitle the buyer to damages in respect of specified liabilities on a dollar-for-dollar basis.
  - unlike in the case of a claim for damages in respect of a breach of warranties, a claimant under an indemnity has no legal duty to mitigate the loss – although the amount of the claim may be adjusted by the court if found to be unreasonable.
Disclosure letter

- Transactions are typically based on the principle of “caveat emptor”
- The buyer will seek to meet this “caveat emptor” rule by insisting that the seller becomes legally liable for its representations, if proved to be false, and by demanding warranties against potential risks and indemnities for specified liabilities
- Warranties are sought in respect of matters that are of particular concern to the buyer, and giving such warranties, the seller will seek to limit its liability for a breach of warranty by making disclosures against them
- The disclosure (in a Disclosure Letter) removes from the buyer the entitlement to sue the seller in respect of the information that has been disclosed
  - i.e. the disclosure invites the buyer to reconsider whether it is willing to pay the suggested purchase price in the light of the new information disclosed

Caution on warranties & indemnities

- Temptation to mitigate transaction risks by extracting warranties and indemnities from a seller in respect of those issues that would normally have been covered by due diligence:
  - This approach is dangerously inadequate:
    - A risk will not be assessed either in terms of probability or size – lost opportunity to reduce price
    - Sellers are more cooperative prior to completion but may resist even well-founded claims afterwards
    - Warranties and indemnities will be limited both as to time and amount – eventual claim may be larger than allowed for, or even be time-barred
    - The seller may not be sufficiently solvent to cover the damages sought
    - The “to the best of the seller’s knowledge and belief” phrase may allow a seller to avoid liability despite acknowledging the loss suffered by the buyer

Post completion price adjustment

- A Share Purchase Agreement may provide that the price paid for shares is subject to confirmation by the parties’ accountants after a completion audit so that the net assets of the company as at the completion date are no less than a certain agreed amount at such date. Typical matters that require adjusting for include:
  - Valuation of assets
  - The cash balance at the valuation date etc
- Upon finalising the completion accounts and determining the net assets of a company, a reconciliation payment may be required to be made by the buyer, or the seller depending on whether the actual amount of the company’s net assets as at the completion date are greater or lower than the net assets amount agreed at completion.
Post completion price adjustment.../2

(i) As an alternative to using a post-completion price adjustment mechanism based on completion accounts, the parties could agree to use a “locked box” approach, where:

(ii) the seller gives robust warranties with regard to the latest audited accounts and management accounts confirming the net assets of the company

(iii) the buyer carries out a thorough financial due diligence to obtain comfort that the latest management accounts accurately reflect the state of the company and confirm that the company’s level of working capital at completion is normal

(iv) the seller indemnifies the buyer for any “leakage” from the company since the date of the audited accounts (eg payment of dividends, distribution or other similar payments to the seller).

Ensuring the purchase price is protected requires careful consideration depending on the circumstances of the relevant company.

The Shareholders Agreement

Purpose of Shareholders’ Agreements

- To give individual shareholders personal rights which would be unenforceable if contained in the Articles of Association
- To regulate specific relationships between shareholders which are not concerned with the general administration of the company
- To provide protection to minority shareholders in addition to those available in the general provisions of the Companies Acts
- To preserve confidentiality as, although some matters contained in the Shareholders’ Agreement could equally well be placed in the Articles of Association, the latter are available to public inspection
The Agreement

- Parties to the agreement
  - All shareholders
  - The company
- Must specifically state that none of its provisions shall be deemed to constitute a partnership between the shareholders
- Must set out the objectives of the business
- Must state that the business of the company should be conducted in the best interest of the company on sound commercial profit making principles so as to maximise the values of the shares
- It is sensible to include a Business Plan as an appendix

The Agreement.../2

- Fairly long list of things the company cannot do without the approval of the blocking percentage
  - Borrow money or incur liabilities other than in the normal course of business
  - Create fixed or floating charge or other encumbrance over the assets of the company
  - Give any indemnity or guarantee
  - Dispose of a material part of the business
  - Enter into any contract involving capital expenditure exceeding $[specified amount]
  - Engage any new employee or consultant at a total remuneration exceeding $[specified amount] per annum
  - Rent any property at a cost exceeding $[specified amount] per month
- Increase the share capital of the company beyond $[specified amount]

The Agreement.../3

- Things the company cannot do without the approval of the blocking percentage (...cont'd)
  - Create, acquire or dispose of any subsidiary
  - Except in the normal course of business, enter into any partnership or profit sharing agreement with any person
  - Do anything whereby the company may be wound up
  - Issue options, warrants, debentures or other securities convertible into securities or debentures
  - Enter into any contract or transaction except in the normal course of business
  - Purchase any shares, debentures, mortgages or securities in any company, trust or other body
The Agreement…/4

- Things the company cannot do without the approval of the blocking percentage (...cont’d)
  - Appoint any bankers to the Company or any subsidiary except [nominated bankers]
  - Except in the case of existing service contracts, take on any obligation to pay money to any shareholder of the company
  - Appoint any committee of the directors or delegate any of the powers of the directors to such Committee
  - Set up any pension scheme of life assurance benefit for any director or employee
- The agreement must address the disposal or charging of shares: pre-emption rights, new shareholders signing deeds of adherence to agreement
- Non-competition clauses

The Debenture Agreement

Debenture Agreements

- Debenture means different things in different regions:
  - US – unsecured borrowing
  - UK & parts of Asia/Africa – borrowing securc on a “floating charge” over the assets of the company (as opposed to fixed charge over specified assets, which take seniority)
- Debentures have no voting rights but sometimes include convertible features
- They free specific assets of the company for asset finance and other senior secured borrowing, making them an attractive form of debt attractive to investees
- The are often transferable, this feature making them attractive to investors
Execution

Where the “rubber meets the road”

- Executing paperwork
- Cash transfers and share transfers
- Public Relations
- Celebrate

Transaction Documents

- Identify all the transaction documents needed
- Review compliance with conditions precedent to contract effectiveness well before execution
- Make sure final negotiated copies are agreed beforehand
- Agree on sequencing of execution if appropriate
- Agree if execution in counterparts is acceptable
- Set appropriate dates and venues which are clear to all
Cash and share transfers

- Review compliance with all conditions precedent to disbursement and/or share transfer well before transaction execution
- Reconfirm bank and share custodian details
- Reconfirm formula for determining and setting exchange rates, interest rates and related details
- Use escrow arrangements as necessary
- Ensure agreed cash disbursement request format is clear and followed

Public Relations

- Agree on PR strategy (which should be aligned with brand strategy) well before execution date
- Agree on PR agents and channels to be used beforehand
- Draft, circulate and agree on press statements – these should be carefully crafted to take account of brand strategy
- CELEBRATE appropriately
- Monitor, and if necessary (usually not), correct any press reports published at the earliest opportunity