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Key Considerations in Acquisitions of Acquisitive Companies

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In a market with soaring multiples, private equity buyers are increasingly on the hunt to mitigate high valuations by acquiring platform companies from which they can pursue add-ons at materially lower multiples and with the potential for synergies. And given the current seller-friendly market, sellers are increasingly seeking to receive premiums for platform companies with add-on potential. In this article, we summarize the complexities that often arise in addressing the potential or pending acquisition of an add-on target (the "Add-On") in a definitive acquisition agreement for a target platform company (the "Target") and the principal methods used by buyers and sellers in recent transactions to address such complexities.

(a) Purchase Price. The table below describes some of the issues that thoughtful buyers and sellers will need to work through in situations where a Target has one or more Add-On acquisitions in the pipeline. We note that there are plenty of examples of purchase agreements that don't contemplate these mechanics even where a Target has signed up an Add-On prior to going out to potential buyers, and generally that leads to a very buyer-friendly result (consider quickly the example where an Add-On closes prior to the Target closing, with the buyer simply paying less cash to the Target as a result of the net debt that it has assumed to acquire the Add-On). And conversely, there are plenty of purchase agreements that simply build an assumption into the purchase agreement that the buyer is paying for the EBITDA associated with the Add-On, which could lead to a very seller-friendly result (consider what happens if the deal never closes). And even with some of the details below, there are myriad other mathematical complexities that will come up in the nuanced drafting that these situations require.

	Definitive Agreement for Add-On Signs on or before Target Signs, and Closes on or before Target Closes	Definitive Agreement for Add-On Signs before or after Target Signs, and Closes after Target Closes	Add-On LOI signed before Target Closes
Enterprise Value and Equity Value	In this situation, the seller will frequently request "credit" for additional EBITDA associated with the Add-On. Fundamentally, the seller is asking for the buyer to pay for the incremental EBITDA at the deal multiple for the Target acquisition. Frequently, the parties will hardwire the increased value of the Add-On into the Target enterprise value (and as discussed in the next column, the parties will then need to solve for what happens if the Add-On deal does not close). The complexity is that if the Add-On deal closes prior to the closing of the Target deal, absent provisions in the Target purchase agreement to address the Add-On, the buyer will pay less for the Target because the Target will have had to pay for the Add-On through either outlay of cash or assumption of debt (causing the net debt of the Target to increase, and purchase price to decrease). Thus, the Target purchase price mechanics must take into account the flow of funds associated with the Add-On deal. There are myriad ways that this can be addressed as a technical matter, with the primary driver of the math being the manner in which the buyer ascribes value to the Add-On.	Similar to the situation where the Add-On closes before the Target closing, in this situation, the seller will frequently ask for "credit" for additional EBITDA associated with the Add-On, unless there are reasons (e.g., anti-trust) for there to be reasonable doubt as to whether the Add-On acquisition will close. And that raises the key consideration in this situation as to what happens if the Add-On does not close. A customary way to address this is for the Target acquisition agreement to give the seller credit for the Add-On but then to include a post-closing adjustment, pursuant to which there is an adjustment in the buyer's favor if the Add-On does not close within some reasonable period of time following the Target closing (which adjustment would equal the value ascribed to the Add-On in the Target acquisition). Despite the above complexities, the purchase price mechanics in the Target acquisition agreement are more straightforward where the Add-On closes after the Target closing, in that the cash and debt position of the Target at closing will generally not be affected by the flow of funds associated with the Add-On deal. Note though that depending upon how the Add-On is valued for purposes of the Target acquisition, the buyer may need to take the Add-On's net debt into account in the Target purchase price mechanics.	Given the uncertainty of an LOI and all the things that need to happen to get from a high level agreement on terms to a closed deal, buyers often will not ascribe value to an Add-on that is only under LOI at the time that the Target acquisition signs. That said, we have seen at least one aggressive seller ask to be paid for incremental EBITDA attributable to the Add-On on the basis of a non-binding but executed LOI. In theory, the purchase price mechanics related to a signed LOI would be similar to the mechanics where there is a definitive signed acquisition agreement for the Add-On, but it would need to be a very competitive auction for a seller to reasonably expect to be given "credit" in this situation.
Contingent Payments	If the Add-On acquisition agreement provides for contingent payments payable post-closing (such as earn-outs), the buyer should consider whether the aggregate value of any potential contingent payment obligations provided under the definitive agreement for the Add-On should be treated as indebtedness of the Target for purposes of calculating the purchase price for the Target. The seller of course would argue	The analysis is the same in this situation as in the preceding column, and the buyer should consider who should bear the burden of the contingent payment. Ultimately the key question in both scenarios is how the buyer is underwriting the EBITDA that is ascribed to the Add-On.	If a buyer is willing to give a seller credit for an Add-On based on just an LOI, that buyer may be able to recoup some of that value by insisting that any potential contingent payments be taken into account in the Target purchase price (here again, the buyer could request that the aggregate value of the potential contingent payments be

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	in this situation that the buyer is the beneficiary of the increased value of the Add-On which would beget the contingent payment.		treated as Target indebtedness).
Transaction Expenses	The payment of transaction expenses is a place where a thoughtful seller can extract material value from a buyer. In the scenario where the Add-On deal closes prior the Target closing, the Target will have borne expenses that are – arguably – for the Target's (and not the seller's) benefit. On that basis, a seller will want to adjust the Target purchase price by effectively getting an increase for those expenses (which otherwise would have decreased the cash that the seller would have received from by the buyer). To counter this, a buyer could seek to cap these expenses, split them with the seller, negotiate a specific list of identified costs and expenses that are payable by the buyer or otherwise require the pre-approval by the buyer of all potentially reimbursable transaction expenses before they are incurred.	The transaction expenses associated with the Add-On in this case would – without any adjustment to the Target purchase price – be borne by both the seller (assuming that the expenses are trued up at the Target closing) and the buyer. That type of rough justice may be the right result, depending of course upon the extent to which the expenses have accrued as of the Target closing. An important note here is that both buyer and seller should be thoughtful about how Transaction Expenses are defined in the Target purchase agreement, as the expenses from the Add-On could unwittingly be swept up in a broad definition. That may end up getting to the right business arrangement, but the parties should make sure that they are eyes wide open.	Given how early in the transaction process the parties will be, a seller is unlikely to succeed in requiring reimbursement of transaction expenses for the potential Add-On, which should remain low at this stage. At a high level, in the situation where the seller has successfully extracted value from the buyer for Add-Ons that may or may not close, it would be exceedingly aggressive to then also ask for the buyer to true the seller up for these amounts.

(b) Timing. There are other timing considerations beyond just the purchase price mechanics. For example, the buyer may seek to make the Add-On acquisition a condition to closing the Target acquisition if the Add-On is deemed valuable enough to the buyer and fundamental to its investment in the Target, or if the buyer has agreed to pay a significant premium for the Target as a result of the potential Add-On acquisition. Whether the seller is willing to agree to this conditionality, however, will depend on the buyer's leverage and how quickly the Add-On closing is expected to occur and the level of certainty the seller has with respect to the Add-On closing actually occurring. In some cases the buyer will have leverage to the extent that the seller would need incremental financing to close the Add-On (which may counteract the lack of leverage a buyer will generally have in an auction process). And so depending again on leverage and the context of the acquisition, a better option may be for the buyer and the seller to agree that the pursuit of the Add-On will be suspended until after the Target closing, leaving the Add-On acquisition entirely in the hands of the buyer. If time permits, this route can avoid wasting time and resources in negotiating some of the complexities discussed above and provide greater certainty with respect to the Target closing.

In addition, whether it is a condition to the Target closing or not, suspending the Add-On acquisition can avoid material delays to the Target closing, particularly where the Target acquisition requires regulatory or similar clearances to be obtained as conditions to the Target closing. As the Add-On acquisition progresses, the parties may need to inform applicable regulators or submit new or revised filings, all of which could delay clearance processes and ultimately the Target closing. The buyer will also need to be wary of “gun-jumping” when negotiating with respect to the Add-On, in that U.S. antitrust laws will prohibit the buyer from asking the Target to pursue the transaction prior to the Target closing and prohibit the Target and the buyer from jointly pursuing the Add-On (or at least until after the Target closing).

(c) Other Considerations. The parties should also consider how the potential Add-On acquisition could impact other provisions in the Target acquisition agreement, such as representations, warranties and covenants. Where the Add-On acquisition agreement has not yet been signed, both parties will be concerned with striking a balance with respect to control over the Add-On acquisition process in pre-closing covenants. If an Add-On acquisition agreement or LOI is signed prior to the Target closing, the seller should be obligated under the Target acquisition agreement to use reasonable best efforts to close the Add-On transaction prior to the Target closing (to the extent not restricted by any necessary approval or waiting periods). Where the Add-On acquisition agreement has been signed prior to the execution of the Target acquisition agreement and the Add-On closing will (or may) occur prior to the Target closing, the parties will also need to determine whether the Add-On is deemed a subsidiary of the Target in the Target acquisition agreement, including for purposes of making company representations and compliance with covenants binding the Target group. In addition, during the interim period, the buyer will usually seek to include a prohibition on amending, terminating or waiving any right, obligation or other term in any LOI or the Add-On acquisition agreement, as well as any financing documents entered into by the Target and/or the Add-On, without the consent of the buyer. Additionally, buyers should consider structuring the acquisition of the Target in a manner that facilitates providing a tax-free rollover to Add-On sellers, for example, by structuring the acquisition of the Target via a flow-through entity.

In summary, if a buyer is agreeing to pay more for a Target due to a potential Add-On, there are myriad complexities and there is no “market”. A buyer’s ability to negotiate against the seller’s demands will ultimately depend on its leverage (e.g., whether they are in a robust auction or a proprietary situation) and also how far down the road the seller is with respect to Add-On. And here as ever, the most important thing for a buyer is to be aware of these complexities (and to work with thoughtful advisors to confront those complexities).

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