Trends & Issues in M&A in 2009 For Venture-Backed Companies

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Probable Drivers of M&A in 2009

- M&A activity will unfold against the backdrop of:
  - Broad market/economic conditions & trends will dominate
  - But individual circumstances & bargaining power matter
    - Good companies with good boards, management, investors, and advisers, will do deals and get better terms
  - Developments in policy, law, regulation
    - New administration, new policy priorities will drive M&A and investment
    - Evolution of relationship between Government & Silicon Valley (and broader venture entrepreneurial community)

Major Recent Developments, Trends & Uncertainties

- Extremely weak IPO markets normally force more 'M&A exits'
- Drop in public and private equity valuations, continuing volatility = new challenges to reach agreement – and then hold deals together to reach closing (and to hold original terms)
- Collapse of storied investment banks, restructuring of Wall Street = fewer & more distracted dealmakers, disruption
- Credit markets collapse & diminished acquisition financing, investor resistance to capital calls affects all buyers but has disproportionate effect on PE buyers & bolt-on deals by PE portfolio companies. More "all-equity" (no-debt) deals. Mid-market PE stronger? Upshot = smaller buyer pool, more weighted to strategic buyers.

Major Recent Developments, Trends & Uncertainties

- With the risks of an unprecedented business downturn, will buyers see
  - a time to buy?
  - a time to wait for even better opportunities and prices?
  - a time to stay out entirely either in fear of catching falling knives? or to conserve cash in fear of an even longer and deeper downturn and continued dysfunctionality in bank lending and the debt markets?

Major Recent Developments, Trends & Uncertainties

- Cyclical downturn?
- Or long-term reset of consumer and business spending to new lower levels
- Sellers hoping for recovery may resist new lower valuations
- Historically, it takes time for expectations to reset
- But have we seen bottom? Or will valuations be lower and conditions be worse in 6-12 months?

Probable Effect on M&A in 2009

- Reduced M&A activity overall, with a shift in mix
- More underwater sales; more potential for internecine "class (and series) warfare"; more private-to-privates; more carve-outs from larger companies; and, without a recovery, more forced sales & distressed deals, prepacks & bankruptcy sales
- Longer & choppier deal cycles
- More pressure on price on front-end (expect more earn-outs, other contingent & deferred payment structures) and back end (more & longer indemnification/escrow)
- Tougher terms for sellers overall
- More failed auctions, retrades, broken deals, buyer remorse

Probable Effect on M&A in 2009

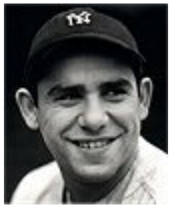
- Upshot:
- A “buyer’s market” but with few buyers rushing to buy
- More “black swan” events, with more traps & challenges for dealmakers & advisers – premium on experience & advice from seasoned hands that have navigated in past storms

M&A 2009: a Buyer's Market with No Rush by Buyers to Buy

- One CEO's view: "a wait-and-see approach about acquisitions" based on the expectation that "the price of potential targets would fall further."

- (as reported in The New York Times Friday, January 23, 2009)

Major Trends – “déjà vu all over again”?



- Still early in the cycle
- Shape, length and depth of downturn (“U”, “V”, or “L”) will be
- But past is instructive and likely outlines are emerging
  - More pressure on price (front-end and back-end)
  - Less certainty of closing (conditions, outs)
  - More asset deals
  - More negotiation over remedies
  - New traps & fault lines

Key Pressure Point = Price in All Its Forms

- Valuation and price under pressure
- Auctions with multiple bids giving way to lone bids
- More price renegotiation at all stages
  - From term sheet to signing, & from signing to closing
- More price adjustments on front end
  - Closing adjustments (balance sheet, other financial statement metrics)
  - Automatic upfront adjustments for capitalization changes, excess deal expenses, taxes, specific liabilities
  - Move from back-end to front-end may mean more first-dollar, $-for-$ adjustments

Key Pressure Point = Price in All Its Forms

- Price becoming more back-end-loaded
  - Earn-outs, other contingent consideration
  - Installment payments and other tranched payments
- More back-end price erosion & claw-backs
  - Indemnification (higher caps, lower baskets, first-dollar rollbacks instead of deductibles, longer, shrinking scope of sole/exclusive remedy clauses and growing carve-outs)
  - Hold-backs vs. escrows
  - Setoff rights, delayed consideration as additional pool
  - Tighter reps → more back-end price erosion exposure
  - Recent anecdotal indications: sole/exclusive & carve-outs more in play, special treatment for identified exposures (no basket, separate higher cap & longer term, general creep up & out)
  - Tradeoffs

Deal Term Trends in Sales of VC-Backed Companies

- The following pages summarize data on selected key deal terms for 2001-2007. Data for sales of venture-backed companies in 2008 is being analyzed and will be reported in the WilmerHale 2009 M&A Report. Data for 2004-2007 is based on transactions involving venture-backed targets (as reported in Dow Jones VentureOne) where the merger documentation was publicly available and the deal value was $25 million or more. Data for transactions before 2004 is derived from other proprietary sources believed to be reliable but reflects a smaller pool of transactions. The data is by nature selective and does not purport to be a comprehensive or all-inclusive survey of the market.

Trends in VC-Backed Company M&A Deal Terms

CHARACTERISTICS OF DEALS REVIEWED

- Type of consideration paid in deals reviewed

	2004	2005	2006	2007
Cash	43%	69%	68%	48%
Stock	41%	10%	8%	0%
Cash/Stock	17%	21%	24%	52%

Trends in VC-Backed Company M&A Deal Terms

DEALS WITH EARN OUT

- Deals that provided contingent consideration based upon post-closing performance of the target

	2001-03	2004	2005	2006	2007
Earn-Out	>20%	24%	15%	17%	39%

Trends in VC-Backed Company M&A Deal Terms

SURVIVAL OF REPRESENTATIONS AND WARRANTIES

- Length of time that representations and warranties survived the closing for indemnification purposes

Survival (in months)	2001-2002	2003	2004	2005	2006	2007
Shortest	12	12	6	9	12	6
Longest	36	24	36	24	36	36
Most Frequent	60-40% 12-18	18	12	12	12	Half 12, half 18

Trends in VC-Backed Company M&A Deal Terms

CAPS ON INDEMNIFICATION OBLIGATIONS

- Upper limits on indemnification obligations where representations and warranties survive the closing for indemnification purposes

	2001	2002	2003	2004	2005	2006	2007
With Cap	100%	100%	100%	85%	100%	100%	97%
-- Escrow Amount	93%	83%	90%	72%	79%	84%	78%
-- Purchase Price	7%	NA	10%	7%	5%	2%	9%
-- Exceptions to Limits	33%	50%	42%	74%	73%	84%	97%
No Cap	0%	0%	0%	15%	0%	0%	3%

Trends in VC-Backed Company M&A Deal Terms

ESCROWS

- Deals having escrows securing indemnification obligations of the target's shareholders

	2001-03	2004	2005	2006	2007
% Deals with Escrow	Appr 85%	83%	97%	96%	94%
Lowest % of Deal Value	4%/10%	4%	2%	3%	3%
Highest % of Deal Value	38%	23%	20%	20%	43%
Most Common % of Deal Value	15%	10%-20%	10%	10%	10%

Trends in VC-Backed Company M&A Deal Terms

ESCROWS -- Continued

- Deals having escrows securing indemnification obligations of the target's shareholders

Escrow Length (in months)	2001-03	2004	2005	2006	2007
Shortest	6-12	6	6	12	6
Longest	36	36	24	36	60
Most Frequent	12-18	12	12	12	12-18

Trends in VC-Backed Company M&A Deal Terms

ESCROWS -- Continued

- Deals having escrows securing indemnification obligations of the target's shareholders

	2004	2005	2006	2007
Escrow = Exclusive Remedy	64%	84%	90%	73%
Exceptions to Escrow as Exclusive Remedy	72%	66%	86%	**100%**

Trends in VC-Backed Company M&A Deal Terms

BASKETS FOR INDEMNIFICATION

	2004	2005	2006	2007
Deductible	39%	38%	48%	48%
Threshold	51%	62%	52%	39%

Some Additional Key Terms Under Pressure – Closing Conditions, Termination Rights

- MAE clauses & bringdowns
  - Growing body of court decisions in favor of sellers/targets
  - Buyers pushing more for overrides, e.g., effect of short-term and one-time items, specific $ materiality standard (difficult & problematic; no easy one-size-fits-all solutions), specific clauses as alternative or supplement to general MAE clauses
  - Lessons from past down cycles – more pressure to cover "prospects" (directly or indirectly), more pressure on even common carve-outs (industry-wide, general economic)
  - Additional pitfalls – implications of other reps, provisions (possible evidence of what's "material" and what's not), time-related provisions indicating significant time-frames (e.g., cure periods, "drop-dead" dates)

Some Additional Key Terms Under Pressure – Closing Conditions, Termination Rights

- Other conditions & outs
  - Funding outs
  - Diligence outs (direct or indirect)
  - Reverse fiduciary outs & reverse break-up fees

Remedies Provisions

- Buyer outs, reverse break-up fees, sole/exclusive? cap? exceptions?
- Option or sale?
- Specific performance and remedies clauses
  - Case law
  - Negotiating history

Asset Deals Likely to Increase

- Tough environments have historically meant more asset sales – divestitures, carve-outs, whole-company asset sales
  - For sellers: need for cash, repay debt, refocus business strategy. Asset sales as 'working capital line' of last resort.
  - For buyers: ability to cherrypick among assets & liabilities, avoid at least some liability risks (but not all)
- But many drawbacks for sellers, including:
  - Subject to tax at both corporate & stockholder level
  - Limits on distributions – need for reserves
  - Liquidation – cost & time
- More 3rd party consents → effect on deal certainty, timing, cost, both for buyer & for seller
- More time/expense to negotiate (what's in, what's out, what goes, what stays, what needs to be shared), thorny IP issues

Exchange Ratios

- Fixed vs. floating exchange ratios in periods of extreme volatility
- Collars – historically the band expands in volatile markets
- Stock-price-based walk-away rights appear
- Trend is for collar bands to widen in periods of above-average volatility
- In Nasdaq meltdown of 2000-2002, collars widened from typical ±10% to as much as ±25%

New Shoals Uncovered by the Hundred-Year Storms of 2008

- Cash, "available funds"
- "Ordinary course" provisions in extraordinary times
- Exchange funds, escrow funds and similar funds
- Fairness opinions; instability and change on Wall Street – new issues relating to financial advisers
  - Fairness opinions in acute situations
  - Fairness opinions from vanished banks – watch drafting of reps/ warranties, closing conditions
  - Key-man continuity provisions in engagement letters
  - Engagement tails – Cheshire cat smiles?

Surviving & Thriving on the Sell-Side in 2009 M&A

- Prepare for sale
  - Skittish buyers may be more risk averse than usual
  - Find (and fix or disclose) the problems before the buyer does – manage the information flow & avoid surprises
  - Don't overpromise
- Be proactive about process
- Don't get painted into a corner
  - Hope (and work) for the best & prepare for the worst
  - Seek and create alternatives and fallbacks
- Pick your points – even in extreme conditions with imbalance of leverage, no one wins or loses them all
- Set expectations & priorities; be flexible & ready to trade

Surviving & Thriving on the Sell-Side in 2009 M&A

- Have a seasoned pilot and team for the process, particularly if you're likely to get only one chance to get it right

- Be lucky (look for it; most luck is made with judgment & alertness to opportunity)

Beyond 2009: 2010