A New Framework for Exclusivity

David Goldstone

In the current dealmaking market where demands for exclusivity, with consequent retrades, are rampant, we believe a new framework for the decision to grant exclusivity is needed. As we discussed in the previous article of the exclusivity series, “Exclusivity – The Double-Edged Sword,” the relative power between buyers and sellers in middle market M&A transactions has begun to, if not already, flipped in favor of the seller.

We have identified three situations where exclusivity is beneficial to the seller. Conversely, if none of those scenarios apply, we believe granting exclusivity is likely to decrease the probability of completing a fair deal.

Liquidity Market

Exclusivity is a critical tool to get a deal done in low-liquidity situations. In these cases, either due to market conditions or the asset’s characteristics, there are few, or even one, legitimate buyers. This largely occurs when the risks and future opportunities are difficult to assess for other than a specific few knowledgeable buyers or when conditions make buyers have a higher aversion to risk.

For example, during times of financial stress, buyers may not be able to accurately forecast the underlying drivers of value for an asset and are concerned about equity valuations going to zero. Sellers are willing to compromise to get a deal done, and buyers need time to assure themselves of their ability to mitigate downward forces. In these cases, where time is of the essence and it will take too long to educate multiple buyers, a seller granting exclusivity will help the buyer build conviction for a fair valuation.

“The relative power between buyers and sellers in middle market M&A transactions has begun to, if not already, flipped in favor of the seller.”

Buyer Characteristics

A different permutation to the liquidity demand case occurs when the market knows there is one buyer that has such strategic reasons for owning the asset that there is reluctance to spend time competing against such a buyer. This can be called a single-buyer market. A single-buyer market can result from unique buyer knowledge about an asset, regulatory requirements, or proprietary synergies and strategic rationales. For example, in the lead-up to Illumina’s (at press time yet uncompleted) acquisition of Grail, Illumina and Grail first negotiated a non-binding term sheet prior to the completion of diligence and the drafting of a definitive agreement. At the time, Illumina was the only company with the ability to develop and process Grail’s proprietary cancer detection test. Consequently, a combination with Illumina was the only way for Grail’s shareholders to efficiently commercialize Grail’s intellectual property. The only alternative to a transaction with Illumina was for Grail to conduct an initial public offering, which Grail’s advisors and board determined would result in less value than Illumina was willing to pay.

Because there were no other buyers that could justify a value close to Illumina’s price, Grail’s advisors and board realized granting Illumina exclusivity would help complete a transaction. In single-buyer markets, because there are no realistic alternatives, the negotiations are defacto exclusive. Sellers and their advisors can gain more by granting exclusivity and negotiating improvements to the transaction rather than by maintaining the illusion of competition.

Negotiation Phase

Finally, exclusivity is a useful tool when negotiations become cooperative. If both parties are concentrated on expanding the pie rather than dividing it, sellers' outcomes are improved by restricting their own options. This often occurs when there are substantial costs incurred by the potential buyer to help expand the pie.

> "Sellers and their advisors can gain more by granting exclusivity and negotiating improvements to the transaction rather than by maintaining the illusion of competition."

The most recent common example of exclusivity being used as an effective tool in a transaction is the involvement of special purpose acquisition deals, or SPAC transactions. In SPAC transactions the sponsor (a publicly-traded investment vehicle with no operations) and the target typically first negotiate a fair valuation and terms in a letter of intent and sign an exclusivity agreement. This allows the buyer and seller to team up to seek additional investment to consummate the transaction. Because in SPAC transactions the sponsor rarely has the total capital required to consummate a transaction, the buyer and seller must join forces to convince outside investors to provide the remaining capital. Transaction negotiations often turn cooperative when incentives cause both parties to have similar benefits from completing a transaction that outweigh competitive price negotiations. For example, in a SPAC transaction, sponsors earn return and sellers receive liquidity only after convincing outside investors to help both parties complete a transaction. Alternatively, in a merger of equals, a combination's meaningful unique benefits to both parties mean there is an incentive to work together to diligence and investigate all possible synergies. In cases such as these where negotiations have turned cooperative, exclusivity is a beneficial tool to getting a deal done.

A Tool in the Toolbox

However, granting exclusivity is not always a beneficial tool for completing a transaction. We believe that in a liquid market with marginally differentiated buyers and no obvious opportunities for cooperation—in short, the bread-and-butter transactions of middle-market deal professionals—exclusivity is a tool used for no advantage. A traditional middle-market transaction with a period of exclusive negotiations risks tying up with the buyer who is willing to bid the most prior to exclusivity but who has the most conservative view on diligence findings. In this case, the buyer with the second-highest bid pre-exclusivity might have been the true highest-value buyer. Asking buyers to complete their diligence pre-exclusivity also applies in situations where the market is not liquid, but there is the perception of competition with other hungry buyers. Maintaining negotiating freedom prevents buyers from knowing if they have overpaid and keeps both parties focused on the binding agreement, not an unrealistic expectation set by an unenforceable anchor.

Exclusivity is, just like every other technique or material used in the sale of a business, just another tool in the dealmaker's toolbox. It is also not an on or off switch. Exclusivity may have a purpose even in the most competitive situations, such as in a stage where third party approvals are required, but only after a definitive deal has been negotiated. Whether it is granting of exclusivity, engaging a firm to provide a QOE, or signing a letter of intent, deal makers are creatures of habit and have become accustomed to using these tools in a regular pattern. However, having a hammer does not make everything the professional sees a nail. As conditions and situations change, the effectiveness of the tool should be re-examined.

ZacharyScott.

1200 Fifth Avenue, Suite 1500 Seattle, WA 98101

o: 206.224.7380

zacharyscott.com