New Techniques for Exclusivity

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We have discussed in previous articles in this series how in today's middle market dealmaking environment, granting exclusivity is not necessarily the right course of action for every seller. In part I of the series ("Exclusivity—the Double-Edged Sword"), we noted that the incentives for exclusivity have changed, and in Part II ("A New Framework for Exclusivity"), we identified the three scenarios where granting exclusivity is more beneficial to the seller than the risk of a retrade. In this third and final part of the series, we will outline the tactics that can be used to avoid the harms of exclusivity while still completing a deal.

The tools and tactics when confronting the possibility of granting exclusivity can be grouped into two broad categories. However, as we noted in part II of the series, the successful use of these techniques requires the deal professional to intimately understand the market dynamics. For a seller to have conviction that rejecting a demand for exclusivity is the right course of action, the seller must be convinced that none of the three scenarios discussed in part II apply and that the buyer is convinced there is a credible alternative to the seller at a similarly attractive purchase price. This means that the tactics are either: set buyer expectations that exclusivity is not tenable or structure the process to minimize exclusivity.

Setting Buyer Expectations

Buyers, like all human beings, orient themselves to conform to expectations. When there are no explicit rules, buyers will default to the norm. Based on the historical incentives in the middle market discussed in Part I, the current norm is for buyers to demand exclusivity. Consequently, to avoid granting exclusivity, the seller needs to set the expectation that the process will not involve exclusivity and communicate that plan to the market in advance of bid deadlines. Sellers should not presume they will need to give up exclusivity until after observing the market's reaction to the expectation that final bids will be an executed definitive agreement.

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Reorienting buyer expectations is possible even if that buyer has already requested exclusivity. It is always reasonable for the seller to tell the buyer no. This was used to great effect during the Carlyle acquisition of CommScope in 2010. The bankers at Allen & Company refused Carlyle's first offer that requested exclusivity by agreeing to share additional diligence information for a two-week period until Carlyle submitted a revised, higher proposal. Several rounds of bidding (against itself) and a month later, Carlyle submitted a signable definitive agreement. Middle market deal professionals can apply this example in practice, by countering buyers' requests for exclusivity with access to specific information that is necessary to improve the buyer's offer and a delayed timeline. This signals to buyers that the seller wants to work with them, but that their offer is not yet actionable based on the alternatives (possible other buyers).

Additionally, sellers can set favored buyers' expectations by establishing a real best alternative to granting exclusivity. If one of the final bidders threatens to not conduct further diligence unless granted exclusivity, sellers have sometimes agreed to reimburse that buyer's reasonable diligence expenses—in other words, creating a stalking horse—as a way of keeping the other parties on track. This occurred during Cabela's sale to Bass Pro Shops. Cabela's agreed to reimburse a private equity party's diligence expense to avoid granting exclusivity to Bass Pro, since the private equity group represented a credible alternative. Given that middle market diligence expenses range in the low single millions whereas retrades tend to be larger than that, keeping the pressure on the final bidders may increase transaction proceeds in the long run.

Structuring the Process

Beyond setting buyer expectations, deal professionals also have a few process tools that enable them to minimize the harms of exclusivity. The first is preparation. The deal professional and the seller need to understand what diligence the buyer needs to conduct to complete a deal and provide it in advance of bid deadlines. However, this is not as simple as loading all documents into a virtual data room. The materials must be provided to the buyer at the right time and in order of importance.

For example, on a recent deal, buyers were given access to a comprehensive data site, but because they were unable to understand the complex accounting system used by the seller, none were able to quickly reach the grounded conclusions on value that would allow them to continue the diligence process. To minimize exclusivity, deal professionals must improve the quality of pre-exclusivity diligence and reduce the number of the buyer's unknowns.

Finally, even in the case exclusivity seems inevitable because the seller believes the requesting buyer is the highest bidder, the timeline and diligence process can still be negotiated and structured. For example, in Veoneer's sale to SSW and Qualcomm, the bankers at Morgan Stanley and Rothschild told one of the finalists the demand for exclusivity was unacceptable given the vagueness of the proposed diligence process.

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Veoneer's management worked with the buyer over the following week to set up a three-week diligence period to prepare the documentation of the deal. Like the Veoneer's bankers, sell-side deal professionals should not simply roll over upon a credible demand for exclusivity but rather create milestones and limit the amount of time the buyer has between those milestones. This approach reduces the time out of a competitive process if the selected buyer is unable to see value the same after reviewing additional materials.

New Techniques for a New Framework

In evaluating the great changes to middle market deal making over the past 20 years, we have landed on the fact that the market for mid-sized mergers and acquisitions is far more liquid than it was back at the turn of the millennium. Consequently, the old tools for getting a deal done are no longer as relevant today as they were then, and deal professionals should look to more liquid markets for ideas and tactics to deal with the problems sellers face in negotiations. As asset managers allocate more capital to historically high returning middle market strategies, and as corporate development teams realize that blockbuster mega-mergers produce less value than expected, we expect the middle market to only become more competitive. The tactics and techniques outlined here are sellers' tactics to take advantage of the growing number of situations when exclusivity is not necessary to complete a transaction.

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