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Optimizing Portfolio Companies for Exit

- A VC/PE Lifecycle Viewpoint -

Copenhagen, Denmark

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Issues When Optimizing for Exit – A Lifecycle Approach



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1. When investing - with a view to exit
2. When carrying and managing in portfolio - with a view to exit
3. When preparing for and doing the exit
 - After the exit
 - And . . .
 - Comments on DK, U.S. and UK differences
 - Top 10 Mistakes in Cross-Border M&A

1. Investing with a view to exit



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- Equity documents
- HR issues
- IP and inbound licenses

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1. Investing with a view to exit –

Equity documents (1 of 3)



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- Topics that directly pertain to exit, e.g.:
 - Drag-along (exit trigger) rights – apply to all or key stockholders:
 - Employees
 - University in-licenses that carry shares
 - Tag-along/take-me-along rights – right to sell when key investors also sell.
 - Corporate governance – Board composition, material decision procedures, supermajority rights.
- Possible novel company structures, eg, in US, some use “LLCs” rather than “C corps” as the parent company, with various business units in separate subsidiaries. Enables multiple exits (of subs), and tax benefits.

1. Investing with a view to exit – Equity documents (2 of 3)



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- Are founder/employee stockholders parties to the investment agreement?
 - Rationale. Pros: compliance, certainty, more effective remedy. Cons: cost/benefit, variations, leavers
 - UK yes, US occasionally, DK yes (separate shareholder agreements)
- Due diligence may be more important than reps/warranties
 - By the investee company (and some or all founders?)
 - But, value is limited – what is recourse if company reps/warranties are incorrect (“men of straw”)? Perhaps adjust ownership % of founders?
 - And, reps/warranties under inbound university licenses are usually quite limited – e.g., ownership “yes”, infringement or efficacy, “no”.

1. Investing with a view to exit – Equity Documents (3 of 3)



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- NOTE: these reps/warranties will become the investors' reps/warranties when they exit the company.
 - So due diligence at outset is particularly important
 - Founders agree, upon investment:
 - To give R&W, on exit
 - To give restrictive covenants, on exit
- Example of “hot” diligence issues
 - In UK, the “new” Bribery Act
 - Corporate offense if lack corporate controls
 - No exceptions for “facilitating” payments (unlike the US)
 - Applies to payments to public or private parties (unlike the US, applying only to public parties)
 - Extraterritorial

1. Investing with a view to exit – HR Issues (1)



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- Structure equity incentives to defer taxes on shares until exit.
 - In US/UK, options defer gain; shares generally taxed currently. But, complicated rules in both US/UK
 - In DK, depends on which tax regime
- Capture all the employees' IP ownership, e.g, via assignments.
- Enforceability of “leaver” provisions: US/UK yes, DK yes on options certain categories, on shares subj to fairness (new rule)
- Executive-specific issues
 - “Double trigger” severance package (no DKK/\$\$, unless both change of control/exit and loss of job within XXX months). Common in U.S., not in UK or DK.
 - Selecting and incentivizing the “right” execs
 - Exit bonus: US/UK/DK, yes but some tax and other complications

1. Investing with a view to exit- IP/Inbound License Issues (1 of 2)



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- IP/patent diligence. Basics include:
 - Does Company have all IP for its products?
 - Patent/IP strategy aligned with business strategy?
 - Freedom to operate, without 3rd party interference?
 - Is geography, coverage, scope, etc. right-sized?
 - Right-size the Company's form NDA so not impede later M&A exit diligence.
- Inbound license issues of fundamental value:
 - Royalty structure, royalty base definition, stacking protection.
 - Breadth/scope. E.g., Exclusive or not? Fields of use? Geography? IP include know-how too?
 - Access to materials, equipment, etc. from spinoff source.
 - Right-sizing any indemnification of ultimate licensor.
 - If company is spun-off from another group – get all IP needed when company leaves its corporate group or institution.

1. Investing with a view to exit- IP/Inbound License Issues (2 of 2)



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- If have inbound license, ensure that:
 - Licensor corporation or university (not your company) is accountable to allocate royalties/equity among lab, scientists, other institutions.
- License Issues especially relevant to Exit
 - Avoid change of control clauses that impede exits, down round financings, restructurings
 - Permit assignments
 - Will the license terms fit well with a large buyer – eg, sublicensing permitted, rights extend to affiliates.
 - Avoid inbound license containing obligation to commercialize?

2. While the company is in the portfolio –



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- Investor group issues
- Protecting your VC/PE Fund
 - The Fund
 - Its professionals
 - Its parent company/owners
- IP strategy, business strategy, licensing.

2. While it is in the portfolio – Investor Group Issues (1)



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- Efficient decisions in the investor club with a view to exit.
 - Material decision procedures
 - Limitations on who is entitled to full company info, e.g., depends on size of club, level of ownership
 - Drag alongs (exit triggers) and Take me alongs
 - Crafting investor percentages.
- Changes in investor group
 - Via portfolio sales, or new investors in subsequent rounds.
 - Contributions by investor syndicate members to building value, and preparing for exit
 - Venture debt

2. While it is in the portfolio – Protecting VC/PE with view to exit (1 of 2)



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- Fund's professionals who serve on boards
 - Obtain indemnification via agreements with portfolio companies, and via corporate formation documents
 - In UK – special rules on scope of indemnifications (“QTPIPs”)
 - In US – better protection if portfolio company is a limited liability company (LLC) rather than a corporation.
 - In DK – evaluate violation of financial assistance rules
 - D&O insurance
 - Each of portfolio company and Fund should carry.
 - Is aggregate coverage high enough?
 - Include “Side A” coverage (ie, specifically in favor of directors, not portfolio company).
- Conflicts of interest
 - How protect and manage for “down” rounds
 - Special issues for corporate VCs, eg, access to info owned by portfolio companies

2. While it is in the portfolio – Protecting VC/PE with view to exit (2 of 2)



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- Good corporate governance in directorships.

Examples:

- Compliance with UK Bribery Act and US FCPA – at risk of criminal penalties for Board members (eg, PE/VCs).

2. While it is in the portfolio – For IP-rich Targets (1)



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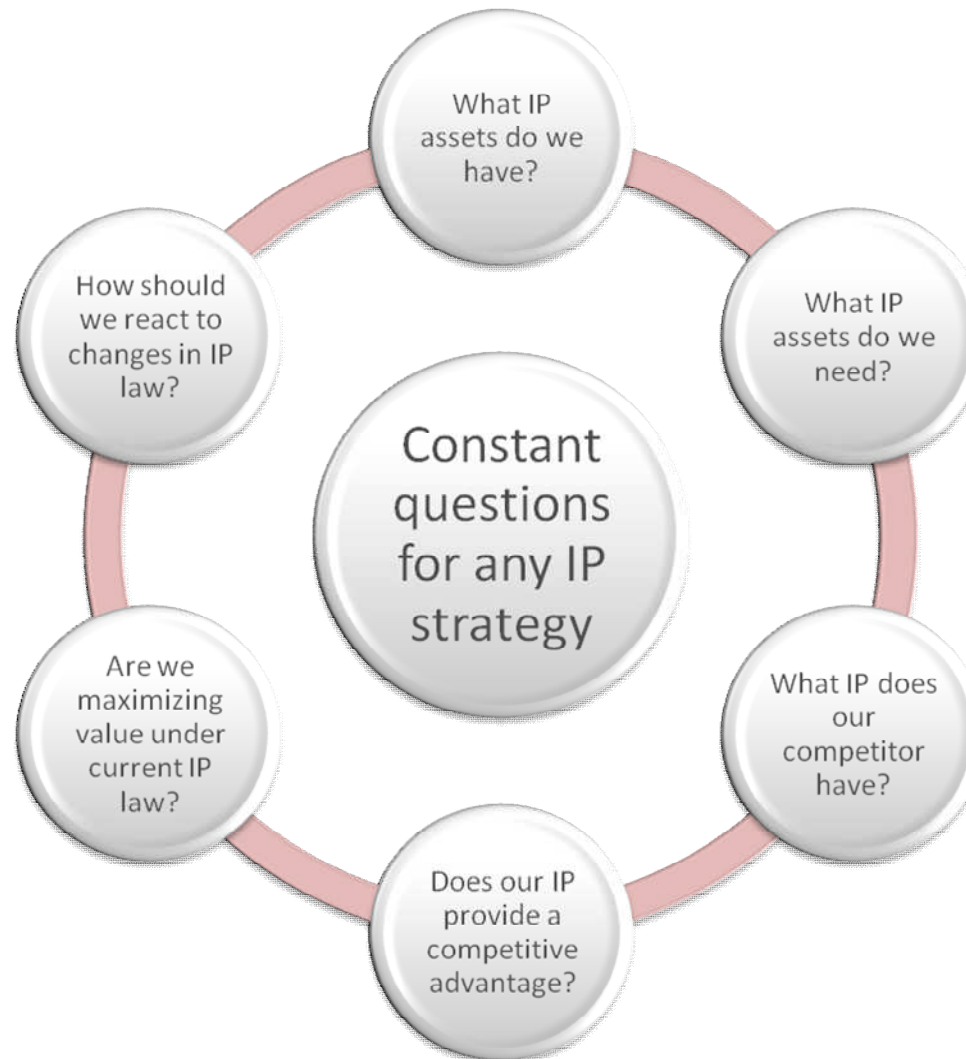
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2. While it is in the portfolio – Pre-exit focus areas from financial viewpoint (1 of 2)



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- Position the business
 - Debt story (sustainable cash flow)
 - Equity story (future growth)
 - What number will potential buyers bid off (LTM, outturn, runrate)
 - What comparable transactions (multiples)
 - Strategic analysis
- Groom the business
 - Prepare business plan/projections model. Consider effect of seasonality on timing of exit process
 - Analyze business KPIs/form commercial view
 - Consider carve outs/restructuring pre-exit
 - Review
 - Operational savings
 - Capex spend/requirements
 - Balance sheet – optimization possible?
 - Accounting policies; need for IFRS accounts?
 - Tax planning

2. While it is in the portfolio – Pre-exit focus areas - a financial viewpoint (2 of 2)



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■ Anticipate due diligence

- Assess quality of earnings/normalised EBIT(DA)
- Net debt – what included/what not
- Assess net working capital to support the business – define, monitor
- Evaluate business plan/projections – are they robust; evidence to support assumptions?
 - Buyers use historical KPIs to evaluate business plan
 - Need “tidy” historical info to support assumptions going forward
 - Ensure current year operations are on (or ahead of) budget
 - Consider vendor DD reports (legal, financial, commercial etc.)
 - Identify key ‘soft’ spots. Avoid last minute surprises, downward price adjustments
 - Ensure equality/quality of info for all parties

3. At exit, when doing the deal



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- Basic M&A value-propositions and drivers
- Valuation/price
- Pre-merger planning for post-merger integration
- Basic deal structures
- Deal process, deal protection
- And, Top Ten Mistakes

3. At exit, when doing the deal –

Basic M&A value-propositions, drivers^(1 of 2)



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- How value targets that lack revenues, profits; have assets in development; require additional cash to be invested.
- Recent study - four techniques:
 - Comparables – especially, a favorite of VCs for revenue-poor targets
 - DCF (discounted cash flow)
 - rNPV (risk adjusted net present value)
 - Real options (ie, is there more than a single route to success)
- When to sell? Selling early, but at lower price?
 - End of fund life issues, and/or
 - IRR arbitrage – the time-value of money

3. At exit, when doing the deal – Valuation/price (2 of 2)



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- Effect on value of cross border v. in-country
- Effect of tax or accounting
 - E.g., goodwill goes to P&L in U.S., to balance sheet in UK – affects buyer’s attitude
 - Minimizing local and foreign tax when selling portfolio company in another country
- Strategic rationales for exit, eg.,
 - Is it $1 + 1 = 3$?
 - Or is it defensive – buyer removes IP from market to competitors’ disadvantage, or buyer wants relief from paying royalties to target
- Is price validation needed – e.g., fairness opinions, auctions, etc.

3. At exit, when doing the deal –

Upside protection (1)



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- Bridging valuation differences –
 - Earn outs, etc.
 - Inherent conflict between seller/buyer. One wants separateness/resources; other wants integration
 - Need access to info to verify calculations
 - Ensuring access to resources needed for earn outs
 - Ability to challenge accounting treatment
 - Creditworthiness of buyer
 - CVR (contingent value rights) (see, e.g., Sanofi/Genzyme)
 - Creative use of insurance
 - If buyer discounts price due to perceived risks, cover that risk with insurance

3. At exit, when doing the deal – **Sell Side planning for post-merger issues (1)**



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- Manage buyer's relationship with target's employees
 - Right-time the buyer's access to your employees
 - Retaining employees in the buyer who are necessary for earn out success
 - Allocate some purchase price to key personnel?
- If buyer may be a U.S. public company, anticipate public company issues, e.g.
 - Dress up target with good internal controls
 - Buyer can use shares as currency
 - Good will be a more sensitive issue for US buyer, as it hits the P&L.

3. At exit, when doing the deal – IP Issues (1)



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- Evaluate existing IP/licenses for effects on exit structure, eg:
 - Terminate licenses which might depress value?
 - Settle IP disputes to eliminate deal noise
- Anticipate buyer's IP due diligence – identify weak spots; alleviate if possible:
 - E.g., new patent filings for improvements which have not been filed.
 - Assess complications from IP that is jointly owned with a collaboration partner
 - Avoid industrial intelligence - structure diligence in two stages, one preliminary, one more granular (but with antitrust clean room when necessary).
 - Settle any pending disputes before M&A begins.

3. At exit, when doing the deal – Basic deal structures (1)



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- Type of deal – sale of assets or shares?
- Payment - cash or stock?
- Bridging enterprise value vs. equity value. Locked box vs. closing accounts mechanisms
- For IP-rich targets
 - Use triangular merger in U.S. deals to preserve target's contracts and inbound licenses,
 - Consider a “structured sale” (starts as outbound license; then becomes option to buy)
- Exclusivity measures, eg, no-shop, break-up fees, etc.
- Escrows – VC/PE sellers want to limit post-deal indemnifications to escrowed amount.

3. At exit, when doing the deal – Deal process/deal protection (1)



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- Diligence, e.g., electronic data rooms, assembly of diligence teams; vendor DD reports, etc.
- Consents/approvals - stockholders, drag alongs; 3rd party consents (eg, in an inbound license); antitrust authorities.
- Claims, risks, breach
 - Sunsets, Baskets, Caps – for a VC/PE, key to have escrow caps damages.
 - Remedies – disclaim obligations other than express "indemnification" and fraud/gross negligence.
 - Will buyer waive claims against ex-directors?
 - Purchase rep/warranty insurance for gap coverage.
 - Control of process, e.g., who controls right to sue third parties, who has access to information

3. At exit, when doing the deal – Alternatives to M&A of Company (1)



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- IPOs
 - Possible but current conditions not ideal. Historically tougher for some than for others (eg, biotechs/life science tough)
 - IPO not usually a true “exit” for VC/PE. Rarely can cash out, absent a bull market
 - And, VC/PE normally prefer quick/fast/100% cash out via M&A company sale (and not an IPO), unless very large delta in IPO valuation vs a sale
- Or, sell privately via new systems for matching buyers with sellers (eg, the “Second Market”)
- Or, multiple private exits with single company, via asset-centric structure vs company-centric structure.
- Or, lower costs of public offerings by using ATMs (at the market offerings)

3. At exit, when doing the deal – Top 10 mistakes (1)



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- Poor pre-exit planning for post-exit integration
- Errors in time management
- Buyer's over-optimism
- Poor data security and segmentation
- Overlook 'gotchas' ["sandbagging"]
- Over-engineered documentation
- Under-engineered documentation
- Seller allows excessive post-transaction risk
- Poor management of the professional advisors team
- Poor understanding of the significance of business culture differences

What we covered today – Issues When Optimizing a Portfolio Company



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- Investing with a view to exit
- While you carry and manage it in the portfolio
- When preparing for and doing the exit
- After the exit
- And . . .
 - Comments on U.S. vs UK v. DK differences
 - Top 10 Mistakes in Cross-Border M&A

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