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The Harvard Law School Forum on Corporate Governance and Financial Regulation (https://corpgov.law.harvard.edu/2019/03/19/dual-track-processes-how-to-turbocharge-your-exit/)

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Dual-Track Processes: How to Turbocharge Your Exit

by James Foster, Josh Kaufman, Michal Berkner, Cooley

Exiting an investment is an inherently uncertain process. Even for a thriving business with a viable equity story, committed stakeholders and the right advisers, the final deal terms and valuation are typically guided by factors beyond a company's control. These include prevailing market sentiment, current appetite for acquisitions in a particular sector and the political and economic environment, all of which can change well within a given transaction timetable. In the face of a global economic slowdown, ongoing trade wars, Brexit, heightened market volatility and other sources of uncertainty, it is becoming increasingly important to consider how deals can be run to maximize transaction certainty and achieve optimal valuation.

Pursuing a "dual-track" process involves preparing for an initial public offering at the same time as running a private M&A process, often through an auction. Relative to choosing a single exit strategy, a dual-track process tends to be more complicated and resource-intensive, while also posing some specific risks. However, if the right dynamic is created, a dual-track process can provide visibility of relative valuation and the benefit of optionality, maximizing the chance of securing the most favorable terms. Whether there's a looming threat of a government shutdown or a sudden stock market sell-off, or the auction bids come in below expectations, the alternative track may present a superior exit option. A dual-track process reduces the possibility that the vagaries of the stock market and industry-specific dynamics will have a detrimental effect on the overall exit by opening the investment opportunity to public markets as well as financial and strategic investors, with each influenced by the others.

To determine whether a dual-track process is right for your company, consider these six key questions:

1. Do you have buy-in for the transaction from all relevant stakeholders?

Identifying which stakeholders hold the key to the success of either track is crucial. As well as controlling shareholders, who may need to approve either transaction, the degree of alignment between common and preferred shareholders, the board and senior executives is an important consideration. The nature of an exit will affect the value of any equity held by shareholders, including employee option holders, and so the short- and long-term effects of attracting, incentivizing and retaining the right team should be considered. It is also important to consider the implications of any change of control provisions in material contracts in the M&A scenario, which may require consent from strategic or financial counterparties. Capital intensive businesses will also need to consider the prospective implications of any M&A transaction under their financing facilities, including potential changes to their credit ratings, so it will be necessary to socialize the transaction with lenders ahead of time.

2. Is the objective to achieve a partial or complete exit?

A private sale can be structured to achieve a complete exit for existing equity holders, with possible deferred consideration, earn-outs and escrows. Meanwhile, an IPO, which is typically structured as a primary equity issuance, will generally permit such investors to sell down over time in the public markets, subject to contractual lock-ups with underwriters (typically for 180 days), insider trading restrictions (which can be mitigated through the use of 10b5-1 plans in the United States) and statutory resale restrictions (which, in the United States, can be particularly limiting for affiliated shareholders with large positions).

Even where pre-IPO holders are able to participate in a hybrid primary-secondary IPO, the transaction will not serve as a complete exit for pre-IPO holders since new investors will ensure that they retain significant skin in the game. Stock market forces also make the timing of an eventual outright exit and the final blended valuation of equity sales over time uncertain. However, delayed exit through the public markets may also increase the overall value to pre-IPO holders by allowing them to take advantage of any public market premium.

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For either track, a partial exit gives rise to the question of control. If the pre-IPO holders want to maintain a certain level of influence over a business following the transaction, doing so may be easier in a private sale, through a shareholders' agreement. In an IPO, selling shareholders may choose to adopt a multiclass or an enhanced voting rights equity structure, potentially fettered through "sunset" provisions. However, multiclass and enhanced voting rights structures are only eligible for listing on certain markets, might not receive indexation (losing out on passive investor flows) and have come under scrutiny by investors in the United States due to perceived corporate governance failures at leading technology companies. In each case, the potential benefits of enhanced control rights will need to be weighed against the possible negative impact on valuation.

Where a partial sale process is primarily driven by the need to obtain further investment rather than to achieve an exit, a dual-track process can also be suitable, but a further set of considerations come into play. These include how debt and equity can be used by the business to optimize its cost of capital.

3. Is the IPO track suitable for (and available to) the business?

The requirements of regulators and stock markets vary from venue to venue, but it is necessary to understand whether the business, its track record and financial reporting (audited to the appropriate accounting standard), will meet those requirements. The intended post-transaction ownership will also affect how the offering is structured and its viability.

The usual pros and cons of being a publicly traded company will also need to be considered. Some of the benefits, of course, include the ability to use listed paper as acquisition currency and to offer liquid stock options to employees, heightened corporate visibility and public company premium valuation. These should be balanced with the need to address any outstanding tax, legal or accounting issues that should be remedied before an IPO. It will be more difficult to deal with potential issues in the public eye, due to extensive disclosure requirements and increased exposure to litigation for any material misstatements or omissions in public filings. Having the necessary infrastructure is also key. This includes the additional resources and know-how that will be necessary to maintain the extra administration and reporting requirements of a publicly traded company, particularly in the finance function.

4. What's the time frame?

As for any transaction, timing is one of the key considerations and will determine whether a dual-track process is suitable. Undertaking an IPO typically takes three to six months and a large part of the timetable is influenced by third parties who help prepare and review the offer document. In addition, market timing is critical for an IPO process, and even a promising offering can be stymied by investor reticence in a market downturn. An M&A process can be much shorter, but can be equally sensitive to external processes, such as competition or regulatory clearances.

It is therefore necessary to understand the expected timetable for both tracks, including the maximum time frames for satisfying any conditions to launching/closing. This timetable needs to be assessed in light of the business' cash position, debt obligations and upcoming milestones, as well as the potential "staleness" of financial information. Flexibility to restructure transaction timetables is critical in managing a dual-track process. However, it can be difficult in practice due to the rigors of operating a business while simultaneously coordinating multiple prospective strategic transactions and financial statement staleness considerations in the IPO process.

The business' roadmap (particularly for life sciences companies expecting clinical or regulatory results), cyclicality or seasonality all have the potential to affect the timetables and, like political and market events, can be hard to plan for, whether they are expected or not.

5. Which transaction is most likely to generate the best valuation?

The valuation of a business by public markets vs. a financial or strategic buyer can vary significantly. IPOs are affected by stock market sentiment, volatility and comparisons (whether valid or not) with the recent trading performance of peers. When equity markets are strong, the IPO track can act as a "stalking horse" in eliciting M&A buyers. Valuation in an M&A process, on the other hand, is often driven by considerations such as realizing synergies, pursuing short- versus long-term business plans, obtaining critical assets (often intellectual property), industry consolidation trends and recent comparable transactions.

With a private sale, it will never be possible to know with certainty how the stock market would have valued a business for comparison. But a private sale provides the certainty of proceeds that an IPO can rarely provide to selling shareholders, particularly given customary 90/180/360-day lock-ups. However, pre-IPO companies can and should take the opportunity to assess market receptivity by taking advantage of confidential meetings with investors—dubbed "testing-the-waters" meetings in the United States or "early look" or "pilot fishing" meetings in Europe—subject to restrictions on the nature of the investors and the content of the meetings.

6. Can the business and the deal team cope with the extra demands?

On their own, each of the IPO and M&A processes place significant demands on a business and its management. Having to deal with two processes at once will inevitably put even greater strain on time and resources, so it's necessary to assess the capacity, expertise and experience of the team that will be responsible for the processes, and whether it will be necessary to add supplemental staff or rely more heavily on outside advisers.

A dual-track process can be managed to limit interference with the day-to-day operations of the business. Coordinating/aligning work streams, such as due diligence and the preparation of the business plan that are critical to both processes, is essential and will reduce the costs and disruption of running a dual-track process. For example, preparing an offering document can be aligned with preparing an information memorandum, and aspects of the verification of that offering document can be completed using sources in the virtual data room created for an acquisition process. Select members of management can be appointed to oversee and coordinate both processes. When it comes to outside advisers, most sophisticated advisers can field teams that can advise on both processes, often with some cost savings, while remaining equally incentivized to succeed under either track.

Finally, not all dual-track processes are created equal—there is no "one size fits all." Maintaining confidentiality (of competing valuations, timing, drivers, etc.) is key to the success of a dual-track process, so it's important to limit the size of the deal teams inside and outside of the company, and of course to obtain non-disclosure agreements from prospective M&A counterparties. Opting for an IPO would not require an issuer to disclose the fact of the parallel (abandoned) M&A process, but leaks or intentional disclosure during the process may have adverse consequences for both tracks. Conversely, knowledge that a company may be pursuing an IPO exit could drive the M&A valuation higher, particularly with strategic buyers. The optionality afforded by a dual-track process should be maintained for as long as possible to keep maximum pressure on timing, valuation and general competitive tension. Ultimately, the goal is to play each track off against the other to secure the best overall deal for stakeholders.

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