THE ART OF THE LOI

Understanding what private equity's most common deal doc actually means.

PARKERGALE CAPITAL

159 N. SANGAMON STREET
4TH FLOOR
CHICAGO, IL 60607
PARKERGALE.COM

For any follow-up questions, inquiries or thoughts, please email us at insights@parkergale.com

STRUCTURING THE LOI IS LIKE, "PUTTING TOGETHER THE CONSTITUTION"

A quick LOI Google search yields thousands of results – most related to what a LOI is and how to draft a letter of intent. But results read like a B-school textbook. For those doing actual deal-making, another 'how-to' article is of little help.

Buyers and sellers want past the formalities of layout and legal jargon to understand what the other party is actually saying. In this article, we'll walk term by term through a real LOI. Instead of defining each piece, we offer insights built on twenty years of deal making and hundreds of LOIs to help readers successfully navigate the process. This exercise helps parties build discernment and trust; two essential elements of the LOI stage. We'll describe what's really being said – and share food for thought on how to interpret and proceed.

In a recent interview with ParkerGale, Ryan Harris, partner at Kirkland & Ellis, suggested that structuring the LOI is like, "putting together the Constitution". Yes, it's a framework (albeit, with fewer implications on the future of the free world!), but you need it dialed-in so stakeholders can move in the right direction as they get to work. The preparation, negotiation and documentation that comes with a private equity deal of any size will be tough. But without being directionally and philosophically aligned, namely, via the LOI, the process is downright impossible.

WHY THE LOI MEANS NOTHING, AND EVERYTHING.

> "Trust and reputation are intangibles governing a LOI. In one sense, the LOI is a massively important signal representing buyer interest. In another sense, it is entirely nonbinding and barely worth the paper it's written on."
>
> **ParkerGale Partner Ryan Milligan**

But what makes it so essential is that it is often suggestive about the intent and deal philosophy of the submitting party. Buried in the text are statements indicative of the transparency, genuineness and earnestness of the buyer. A PE deal is wildly disruptive and expensive – even for the most prepared and honest parties. Given this, clarity must be had on what is in store. The LOI is like the executive summary of the rigors to come. And if parties aren't aligned around LOI fundamentals, proceeding can be disastrous. So, despite the inevitable term sharpening, change ups or modifications to come, the LOI lays the foundation on which the deal runs.

INTRODUCTION

The first thing to realize is that the LOI is akin to a sales brochure. At this stage, **the buyer is preening in the deal doc; highlighting their best attributes and credentials to stand out among competitors.** This doesn't have to infer that the partners' letter or preamble is disingenuous, but it's important to not get too caught up in it. Here, our intro letter is about credibility building. What matters here is how the buyer goes about building it. The introduction should prompt key questions.

- Can they point to firm merits that are actually beneficial to getting a deal done? If the seller is a SaaS company, for example, do the partners reference how they only look at software deals?
- Do they offer references or encourage you to talk to bankers or other industry operators that are aware of their reputation to close?
- Is there specific language suggesting that the buyer actually knows your business and has already invested time and resources in cursory due diligence?

If the letter sounds generic, chances are it is. There are firms that churn out LOIs to lock-up as many deals as possible, before only closing a small percentage.

SMART SELLERS ASK QUESTIONS

VALUATION

Generally, what is listed under valuation assumes a 100% purchase of a cash-free and debt-free business. This tends to be a straightforward representation for what is under consideration. Be careful, however, in taking the number at face value. One term sheet trick is for buyers to put a big, headline number out there to entice buyers. Once they lock up the deal, they lean on complicated language in the ongoing negotiation – and debt-like items, transaction expenses, working capital or unsaid assumptions about performance expectations to bring that number back down to earth.

Smart sellers ask questions. They'll ask advisors about a buyer's reputation for negotiation or any bait-and-switch valuation tactics. They will also ask buyers directly about how they arrived at their valuation, which is often some multiple of revenue or EBITDA. This offers pros and cons. First, it allows a seller to understand the inputs and assumptions behind the buyer's number, but it also allows for corrections in an inaccurate EBITDA calc, for example.

This section also exposes the level of pre-deal diligence a buyer has done. Valuation is informed by basic business model, performance, market potential and financial review. And over time, the market has proven pretty efficient in assigning valuation. That big number in a sea of otherwise similar LOIs? It may suggest recklessness or dishonesty. Likewise, if the buyer offers little context underneath the valuation story, assume some deal ambivalence.

STRUCTURE

There are two basic ways to purchase a business:

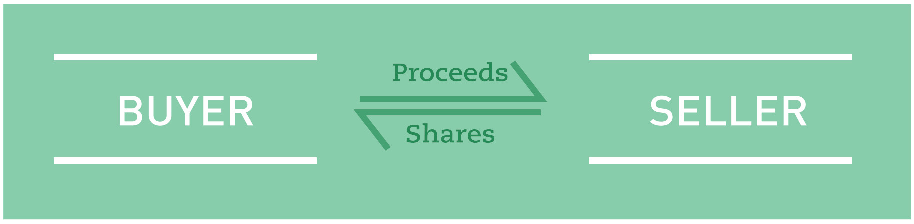
- In the first, one party buys the equity of the business through either a direct stock purchase or by merging two businesses together.
- The second is an asset deal. Here, the buyer doesn't actually buy the company itself, but instead buys all of its assets. This includes everything from physical inventory to people, IP and contracts.

The important part to understand is the level of complexity associated with the deal types and why a buyer may be proposing one over the other. If a business is a sole proprietorship, the deal is easy. There's just a stock transfer to the buyer. If there are twenty shareholders, it's more complex. Stock deals are much cleaner for sellers. The buyer takes 100% of assets and 100% of liabilities, subject to contractually negotiated indemnification in the purchase agreement. The seller takes the cash and leaves with no obligations except repayment in the event of a contract breach. Plus, assuming the seller held the stock for the appropriate holding period, the gain on sale is taxed as capital gains.

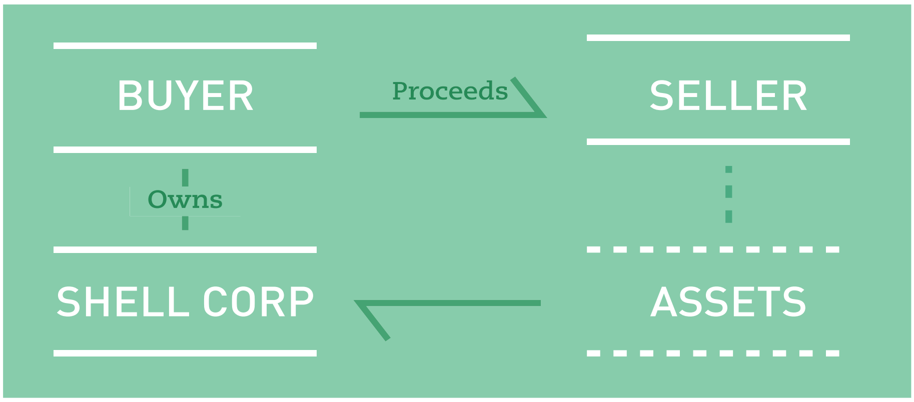
Not so with an asset sale. In this case, the tax could be meaningfully more. As well, unlike the stock deal where the buyer is taking everything – assets and liabilities included – in the asset sale, sellers may be left responsible for liabilities that get carved out. **Buyers often naturally prefer this – and woo sellers into agreeing to it with a high offering price.** Taxes and liabilities are major reasons why the structure of the deal matters as much as the value of the deal.

Sellers be warned: don't tune out the accompanying language when you get reeled in on the big valuation.

STOCK DEAL



ASSET DEAL



PURCHASE AGREEMENT PROCESS AND KEY TERMS

This defines the actual terms of sale agreed upon in the LOI and any new terms or conditions (e.g., indemnification provisions) agreed upon between the buyer and seller.

This section simply indicates what the buyer's response to the draft (if drafted) purchase agreement from the seller is. **The key is for sellers to clearly outline major terms upfront and understand a buyer's specific response to each key term as proposed.** Mr. Harris even suggests a simple, formatted table detailing key terms and requiring a buyer response to each.

The earlier these negotiation points are raised, the more expedient the deal. While the section may be short, how a buyer responds is indicative of their appetite for the deal. Fundamentally, buyers are at a crossroads: redline the heck out of the document and risk souring seller sentiment but reach brass-tax discussion sooner. Or, offer a lighter touch perspective on key terms and punt the heavy negotiation for later. For both parties, understanding the mindset of the other when it comes to the purchase agreement means less surprise, less risk of offense and a clearer go/no-go signal.

TIMING

This section is all about signaling:

- Do buyers suggest an aggressive close date? Can they credibly deliver, or is this just to entice sellers and will running the risk of underdelivering?
- Or, do buyers choose a more realistic, but less competitive tact and build an industry reputation for delivering as outlined?

Sellers, ask around. If the buyer has done some proactive due diligence, they may not be a big talker. They may actually be able to close fast. Similarly, a later date doesn't always imply a penchant for punctuality. If they have a bunch of LOIs out and need to stall, a later date may be more about a buying time than it is sensibility.

SOURCES AND USES

This section outlines where the money actually comes from. For a private equity buyer, it is generally the fund, or from a lender if using debt. It also includes the amount management is expected to roll in and any co-investment. Where this section starts to deviate deal by deal is in Uses.

The Use sub-section shows how much of the purchase price actually gets to the seller. Fees are to be expected – even in this exploratory phase for a deal that may eventually fall apart. We call these "dead deal fees". They're real money costs and critical to account for. If there's debt financing, banks will charge a fee. Even cursory diligence starts the clock on legal fees, and these jump post-LOI signing too. And yes, some funds are even structured to charge fees when capital is pulled down. Language granularity varies in this section, so sellers are wise to ask clarifying questions. They should understand the nature of fees and who they're assigned to. They should also prod for equitability too; are fees reasonable and transparent?

WORKING CAPITAL

The truth is, some sellers are quite lost, or at best, outmatched during a working capital negotiation. In principle, this section exists to ensure that the buyer has enough capital at work in the business to actually run it post acquisition. But it's a highly-negotiated, technical and often contentious point.

On one hand, less scrupulous parties can game the number. For example, a seller may extend out payables and aggressively collect receivables to float working capital assumptions down. Alternatively, buyers can offer a convoluted technical analysis to arrive at a working capital number to create a rich buffer or unexpected windfall post close. Some LOIs may actually offer a number, but in general buyers won't do this until deeper due diligence and purchase agreement negotiations are underway. But **it is a material point of negotiation and becomes a dollar for dollar deduction, or add, to proceeds.** If a LOI comes across the table without a pegged amount, sellers should press to understand a buyer's philosophy, range, or usual formula for assigning working capital. This is a top-five type question to ask references as well.

MANAGEMENT & MANAGEMENT INCENTIVES

These sections outline how the buyer proposes the actual economic treatment of management at deal close. In our LOI, management wasn't a primary owner. But often, they'll become quite interested in what will happen under new bosses.

A common scenario will include a founder that is also in management. This individual may have become accustomed to certain non-market compensation practices, like an additional $1 million per year in distributions. They too will be interested in what a buyer intends. Private equity buyers are generally disinterested in alienating management or doing anything materially disruptive. But sellers will want to confirm basic intent. To reduce confusion, buyers will want to proactively answer common questions without painting themselves into a corner with specificity.

- Will the buyer continue offering market terms to management and open up a common stock pool with reasonable performance and time-based vesting?
- Will there be thought given to tax implications to management comp?

Often, there's the expectation that management rolls money forward into the transaction. If so, that would be explicitly described. Given the buyer's likely end goal of sale, these scenarios could be lucrative for existing managers and incent their staying. Of course, sellers should work to understand the nature of ownership and eventual proceeds. Buyers may not be keen to show it, but not all proposed ownership is created equal. Management could sit below preferred stock owners, while the preferreds enjoy a compounding dividend to boot. This further impacts proceeds for common stockholders upon sale. Part of the seller agenda here will be: figure out if you're getting or buying what they are. Ask for a waterfall example by class for a few different sales scenarios. Any class distinctions will be stark.

FINANCING & BUY-IN

Here, buyers validate the brief references on funds origination from the Sources section. Generally, **the message here should be: there's no way that financing will make this deal fall apart.** Sellers may flex their fund size or boast an all equity offer to show of speed, size and certainty to close. Others will propose equity and debt, but will include lender term sheets and support letters to validate that debt financing is buttoned up. **Savvy sellers don't take the financing plan at face value.** And the last thing you want is some regional bank with a weak track record of closing to veto financing and kill a deal in the 11th hour.

Even in the case of all-equity fund financing, sellers should understand the legitimacy of the fund. Work to determine: **can the fund actually fund what it says it can?** Lots of funds are overcommitted or need three layers of investment committee buy-in. It's fair to probe into the fund's capacity to deliver and ask who controls the equity and final votes.

In our LOI, we liked the deal and wanted to remove any doubt, thus the section on Complete CGP Buy-In. Some firms have a junior team member driving the deal. This means separation between the deal lead and the actual decision-making power. While it's not a deal breaker, consider the implications.

- Any financial hiccup during the run up to close
- Any unexpected finding in due diligence
- Every newly raised point of negotiation

Yep, this person is going to have to go to an investment committee that sees 300 deals per year with no personal connection to the deal and try to explain away, advocate for, or sell to the members why they should continue. It's much easier for the partners to play hardball when they're uninvolved personally. That's why we just say it, "yes, all Partners are on board, and the three Partners involved here are co-founders of the firm and on the investment committee."

PRESS FOR A DETAILED TIMELINE

DUE DILIGENCE

While we tend to spare the gory detail of all due diligence activities and timeline in this section, we always outline the key activities we intend to complete. The reason, of course, is that we're offering tens of millions of dollars for a business and need to hold a seller accountable that what has been shared up to this point is actually true.

No way around it, a seller should prepare to go under an enormous microscope. There will be dozens of advisors, hundreds of questions and an energy sapping period shedding light on years of operations. Perhaps one of the most important takeaways here is that preparation matters. Deal likelihood may hinge on a company's ability to anticipate due diligence needs and prepare accordingly. The due diligence activity list in the LOI should prompt a two-fold response.

First, it offers sellers the opportunity to be additionally forthcoming about any issues they've withheld. The scope of activities and legitimacy of the advisory horsepower involved should jolt them out of the notion that they can sweep anything under the carpet.

Second, it indicates seriousness. This list isn't just about intimidating you with all the intrusive tasks we're waiting to unleash. Buyers should also provide references as part of the list – we did. And we certainly follow up to see if the seller reached out. We anticipate spending $1+ million during the diligence phase. If a seller doesn't reach out to provided references, we might question their intent. They're either too trusting, being naïve, or not ready, and all are yellow flags.

A serious seller will try to glean insight from any- and everyone to understand our philosophy on due diligence.

- Do we use finding after finding as a way to ding sales price and valuation?
- Have we shown an equitable approach to navigating how to address issues raised in diligence?

Sellers should also press for a detailed timeline or Appendix sheet detailing the specific activities. Ask "when do you intend to begin, what are you actually looking for, and why?" A thoughtful buyer will use the opportunity to build trust. They'll share past experiences on how they've used information uncovered in diligence and how the findings impacted a transaction. **Answers are also revealing with respect to the buyer's ability to interpret, digest and solve any issues internally.**

Fundamentally, due diligence is essential because of "the lemon problem." In sales parlance, this means an asset that turns out to have flaws, defects or hidden issues too severe to serve its purpose or warrant its acquisition value. The fear of what's lurking will always drive buyers to negotiate a discount and mitigate the unknowns. But a hands-on, operationally minded firm will be less 'scared' of issues. Assuming a forthcoming management team, they'll often have a less accusatory or contentious posture. They tend to have a wider operational berth, whereas firms that depend on consultants' feedback and third-parties to resolve issues have to take more measured and severe responses in the form of valuation cuts. Their fear of lemons is heightened by their inability to differentiate between a 'lemon-esque' problem and what is navigable (and fixable). Also, firms that squirm when pressed for dates are hedging. They may not be serious, may be buying time to look at other deals or may be hesitant to start running up a tab for diligence.

CONDITIONS

These simple statements offer broad ranging protections and leeway for concerned parties to bail. Their goal is to protect the buyer by reminding parties that there's a lot that still needs to happen between now and an ultimate purchase agreement. Think through the myriad issues requiring negotiation that could derail a deal: status of a buyer's financing, maintenance of a key customer contract or relationship, government regulations, license and permitting, etc. You'll notice a repeat use of the funny little word, satisfactory. This word is dripping with subjectivity. Prepare for hundreds of pages of documentation and an intensive negotiation to deliver a 'satisfactory' ultimate purchase agreement.

EXCLUSIVITY

Buyers know the level of work ahead and typically won't commit unless a seller hits pause on the process with others. Of course, sellers are motivated to keep the deal frothy – to drive as much competition as possible and reduce a disruptive (and morale killing) sale start-and-restart process.

What is rarely discussed is the nature of exclusivity and some of the negotiated flavors. Sometimes, the conditions of exclusivity stipulate that you need to tell the prospective buyer when you're contacted by another buyer. Sometimes, you'll be obliged to not just report the contact, but also share the nature of the offer. Other times, there may be a graduated scale for exclusivity where a seller provides additional time after a minimal first period if a buyer acts in good faith. Playing hardball around this is a delicate dance. A seller may want to bluff around deal interest and offer a small window of exclusivity. A buyer can think, this isn't worth my time. They'll question the value of spending a frenzied two weeks and thousands of dollars when a seller has eyes for another. On the other hand, the unprepared buyer that sprays LOIs may not be competitive when asking for something unreasonable, like ninety days. Few sellers have the appetite for three months of getting due-diligenced to death.

THIS IS THE PARADOX OF THE LOI STAGE – PARTIES MUST BE WILLING TO TRUST ONE ANOTHER, BASED ON THE LIMITED INFORMATION OUTLINED IN THE LOI, AND PROCEED. BUT TRUST IS A BYPRODUCT OF TIME AND EXPERIENCE TOGETHER, AND PARTIES HAVE NEITHER AT THE TIME OF SIGNING.

FEES

At this point, a seller has dragged itself through a half dozen to twenty or more pages of terms. They read the fee section and think, "sure, we each pay our fees and we're good to go." What is standard in this section though is that the new company being created to make this investment pays the fees. If a seller is rolling over a large portion of proceeds into the deal, this matters. Imagine a seller is offloading 50% of the business, for example. Of course fees affect significant rollovers more – but are a necessary evil in getting a deal done.

The LOI is a buyer's statement that "if everything I know turns out true, I will deliver what's included in my LOI to you." Nobody wins when the process drags out or when there are surprises, suspicions or misrepresented intent. This is the paradox of the LOI stage – parties must be willing to trust one another, based on the limited information outlined in the LOI, and proceed. But trust is a byproduct of time and experience together, and parties have neither at the time of signing. At this stage, buyers and sellers don't have the luxury of negotiated details and finer document drafting to make up where trust lacks. **It's why it matters to not just know what the LOI is or how to build one, but how to actually interpret it and understand both the doc itself and those behind it.**