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Middle-Market
M&A
SurveyBook

2018 Survey of Key M&A Deal Terms

Introduction

Seyfarth Shaw LLP is pleased to present the 5th edition of its Middle-Market M&A SurveyBook (“Survey”) which analyzes key transaction terms included in over 120 middle-market (i.e., transactions with a purchase price of less than \$1 billion) private target acquisition agreements signed in 2017.¹ The information presented is intended to serve as a guide to buyers, sellers and deal professionals on “what’s market” when negotiating private target acquisition agreements in what we expect to be a very active 2018.

The Survey focuses on key deal terms comprising the “indemnity package” included in almost all private target acquisition agreements to address a seller’s potential post-closing liability to a buyer, and set the parameters of a buyer’s ability to claw back purchase price from a seller. As is always the case, each deal has unique facts and circumstances that impact the negotiation of the acquisition agreement, including, importantly, the relative leverage of the buyer and seller. It is nonetheless helpful when negotiating an acquisition agreement to have a strong understanding of where the terms of your “indemnity package” fall in the current market spectrum.

The data analyzed in this Survey suggests that, similar to the trend of recent years, the environment for private target middle-market M&A continues to be seller friendly. Additionally, the purchase of representation and warranty (“R&W”) insurance continues to be a powerful tool used by buyers in an effort to make their acquisition proposal more attractive to sellers wishing to limit their potential post-closing liability.² Of course, the terms of the typical indemnity package are greatly impacted when R&W insurance is utilized. For example, the indemnity escrow amount and indemnity cap size are typically drastically lower in transactions using R&W insurance as compared to transactions that do not use such insurance. Accordingly, in order to avoid the skewing of data presented in this Survey as a result of the use of R&W insurance in certain transactions, the graphs and charts presented on the following pages only reflect data from deals that did not utilize R&W insurance. However, we have highlighted the results of the data we collected and “market” information regarding transactions that utilized R&W insurance in our observations provided throughout the Survey.

Overall, general market sentiment indicates that 2018 will be an active year for M&A deals and will likely continue to favor sellers. With the uncertainty surrounding the 2016 U.S. presidential election now behind us, many middle-market deal makers are increasingly optimistic regarding current economic conditions. This optimism has been bolstered by the passing of the new tax cuts and the perceived regulatory temperament of the current administration.³ Capital availability or “dry powder” is at an all-time high on the balance sheets of strategic acquirers. In addition, private equity funds continue to maintain healthy fundraising trends with middle-market funds raising over \$100 billion in commitments every year since 2013.⁴ With high demand from strategic and financial buyers with available capital chasing fewer attractive targets, transaction multiples have hit an all-time high since the Great Recession.⁵ The market is also

seeing an increase in private equity-backed platforms growing their businesses through “add-on” acquisitions which are often focused in the middle-market. For these reasons, we believe that 2018 will follow a strong 2017 year for M&A deal making.

We hope that you find the information presented in this Survey valuable. If you would like more information regarding the data presented, we welcome the opportunity to further discuss our findings with you.

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¹ For purposes of this Survey, “purchase price” means the total cash consideration paid by the buyer in a transaction, but does not include contingent purchase price payments (e.g., earnouts). This Survey does not include any transactions that involved the payment of any consideration other than cash.

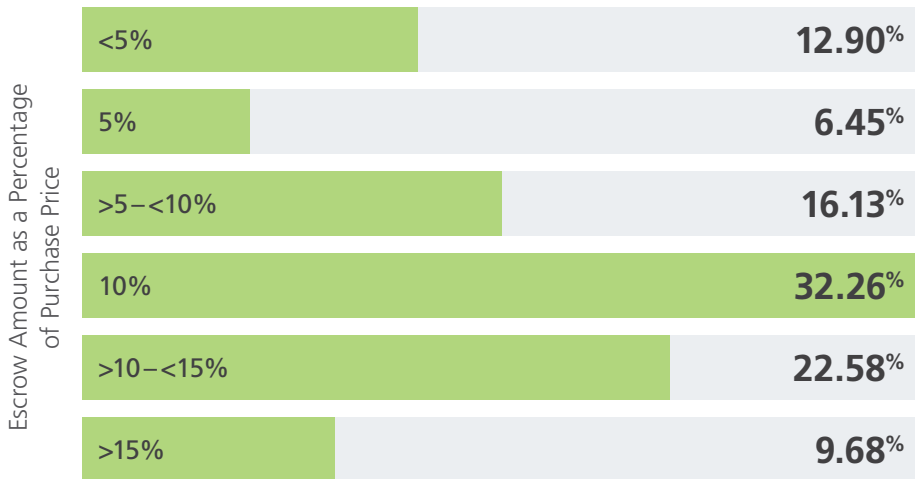
² Over 30% of the transactions reviewed for this Survey utilized R&W insurance.

³ Trends in Middle Market M&A, SourceMedia Mergers & Acquisitions, February 28, 2018.

⁴ Pitchbook 2017 Annual US PE Middle Market Report.

⁵ Quarton International North American Middle Market M&A Update - Fourth Quarter 2017.

Indemnity Escrow Amount*



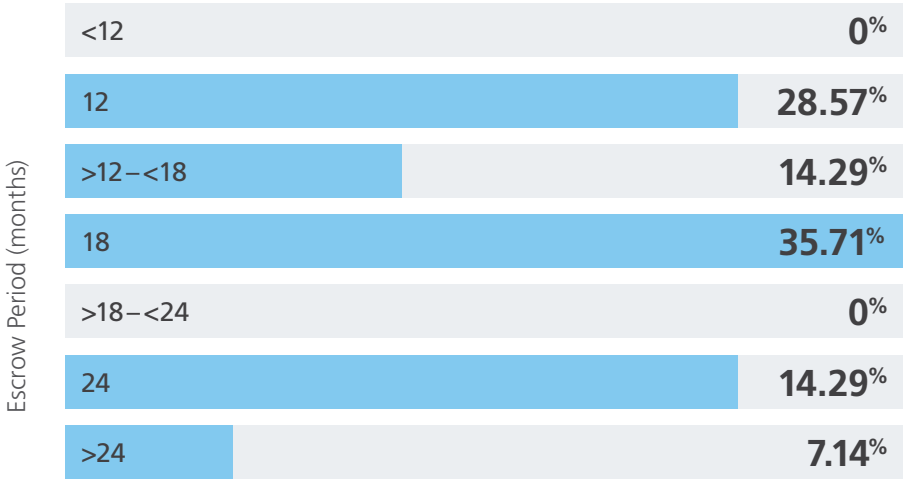
Percentage of Deals Surveyed Providing for Indemnity Escrow

OBSERVATIONS*

- Approximately 36% of all deals surveyed provided for an indemnity escrow. In contrast, approximately 91% of R&W Insured Deals surveyed provided for an indemnity escrow.
- The median escrow amount in 2017 for deals surveyed was 10% of the purchase price, with approximately 35% of deals having an indemnity escrow amount of less than 10% and approximately 13% of deals with an indemnity escrow amount of less than 5%.
- In deals using R&W insurance, the policy typically includes a retention (deductible) equal to approximately 1% of deal value. Putting aside a “no-survival” deal in which the seller will not indemnify the buyer at all for breaches of representations, typically, the buyer and seller will effectively split the retention amount under the policy through a basket in the purchase agreement of 0.5% of the purchase price and an indemnity escrow amount of 0.5% of the purchase price (which also typically reflects the indemnity cap size under the purchase agreement). For example, absent R&W insurance, a purchase agreement may have a 0.5% basket and a 10% indemnity cap with a corresponding escrow amount. However, by using R&W insurance, a seller can reduce the indemnity cap (along with the correlating escrow amount) down to 0.5% to effectively cover (with the basket under the purchase agreement) a 1% retention under the R&W insurance policy.

*** IMPORTANT NOTE:** Unless otherwise stated, the graphs, charts and observations presented in this Survey reflect deals surveyed without R&W insurance (“deals”). References herein to “R&W Insured Deals” refer to deals surveyed that utilized R&W insurance. Data used in this Survey for prior year comparisons has been derived from the results of our prior surveys.

Indemnity Escrow Period*



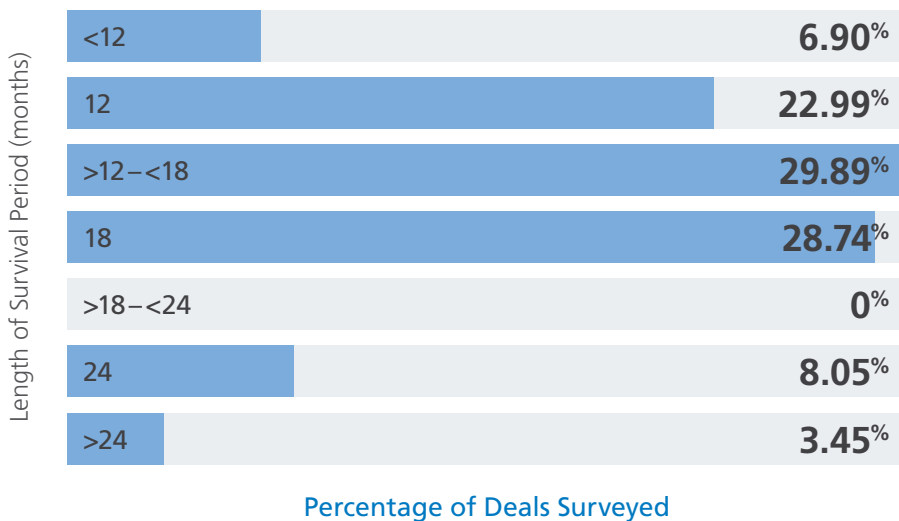
Percentage of Deals Surveyed Providing for Indemnity Escrow

OBSERVATIONS*

Of the deals surveyed which provided for an indemnity escrow:

- The median indemnity escrow period was 15 months, while the median indemnity escrow period for R&W Insured Deals was 14 months.
- The percentage of deals surveyed with an indemnity escrow period of 12 months or less was approximately 29% while over half of the R&W Insured Deals surveyed contained an indemnity escrow period of 12 months or less.
- Interestingly, the percentage of deals with an indemnity escrow period of 24 months or greater continues to increase from 2014 levels. Approximately, 21% of deals surveyed in 2017 had an indemnity escrow period of 24 months or greater, compared to 16% in 2016, 13% in 2015 and 11% in 2014.

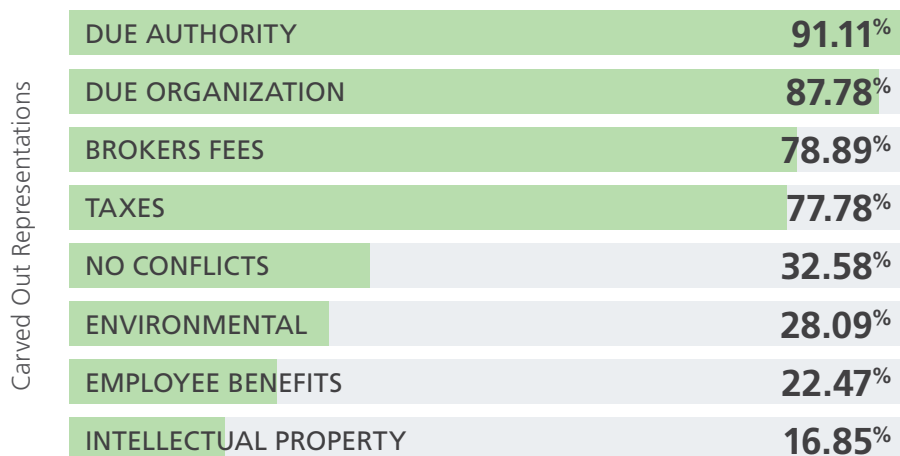
Representation & Warranty General Survival Period*



OBSERVATIONS*

- The median general survival period for deals surveyed was 15 months, which has remained consistent since 2013, while the median survival period for R&W Insured Deals surveyed was 12 months (but it should be noted that the R&W insurance policy effectively extends this period by providing insurance benefits for breach of general representations typically for 3 years).
- Approximately 82% of deals surveyed had survival periods from (and including) 12 to 18 months, which is consistent with prior years (82% in 2016 and 80% in 2015). Similarly, 75% of R&W Insured Deals surveyed had survival periods from (and including) 12 to 18 months (and, as noted above, the survival period is extended by the insurance policy typically to 3 years for general representations).

Carve Outs to General Survival Period*



Percentage of Deals Surveyed in Which Applicable Representation Was Carved Out

OBSERVATIONS*

Employee Benefits and Environmental

- The percentage of deals surveyed that carved out representations and warranties regarding employee benefits was approximately 22% in 2017, reflecting a steady decline when compared to 23% in 2016 and 28% in 2015.
- The percentage of deals surveyed that carved out representations and warranties regarding environmental matters was approximately 28% in 2017, compared to 19% in 2016, reversing a trend in the decline of this carve out since 2013. However, approximately 19% of R&W Insured Deals surveyed carved out representations and warranties regarding environmental matters.

Other Carved Out Representations

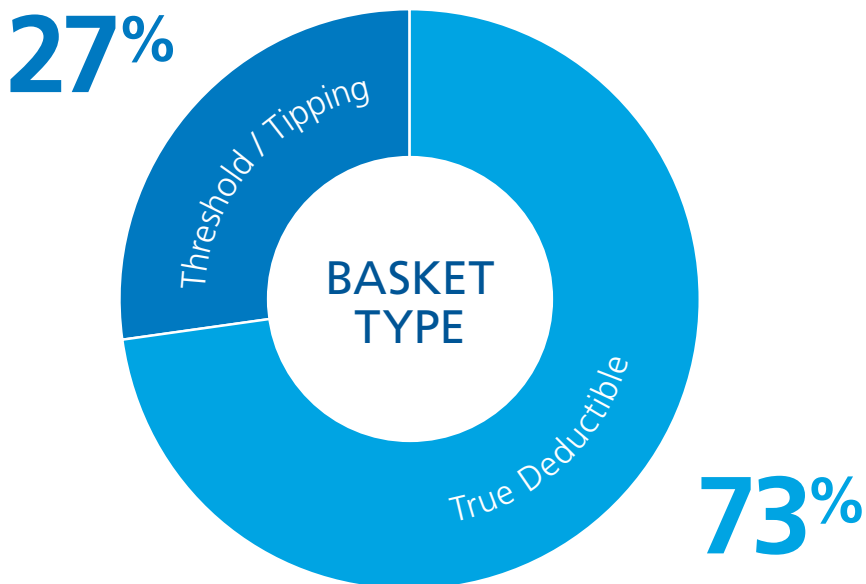
Broker's Fees, Due Authority, Due Organization and Taxes

- Greater than 70% of deals surveyed carved out representations and warranties regarding Broker's Fees, Due Authority, Due Organization and Taxes, often considered "Fundamental" representations and warranties.

Title to Assets

- More than a majority of deals surveyed involving the purchase of assets continue to carve out representations and warranties regarding the title to assets.

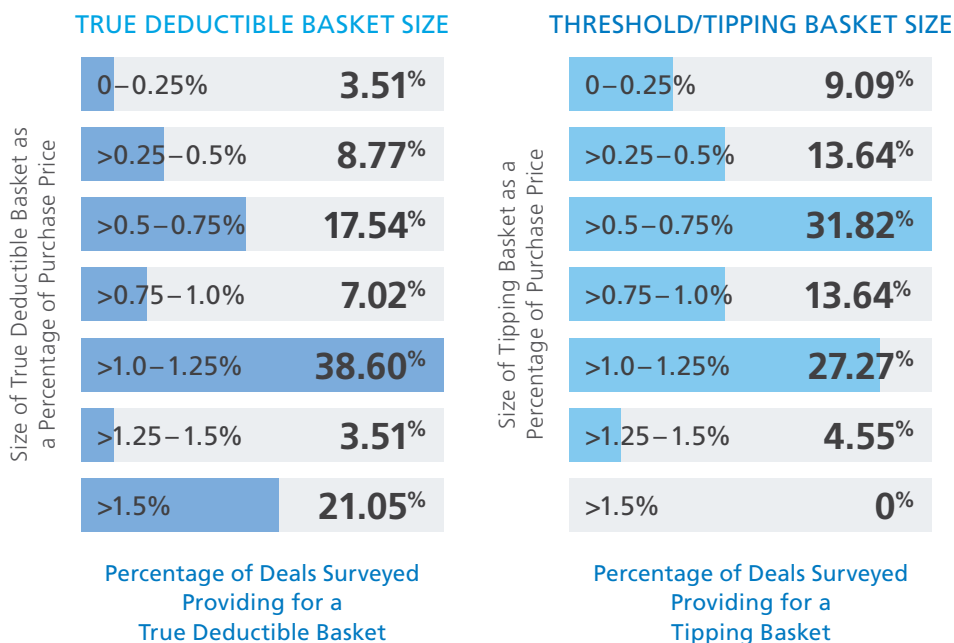
Indemnity Basket Type*



OBSERVATIONS*

- Approximately 91% of deals surveyed provided for an indemnity basket, which is consistent with prior years (91% in 2016, 89% in 2015, and 91% in 2014). Similarly, the vast majority (81%) of R&W Insured Deals surveyed included an indemnity basket.
- Of the deals providing for an indemnity basket, 27% were structured as threshold/tipping baskets and 73% were structured as a deductible. Similarly, an overwhelming majority (86%) of R&W Insured Deals surveyed that included an indemnity basket used a deductible type basket.

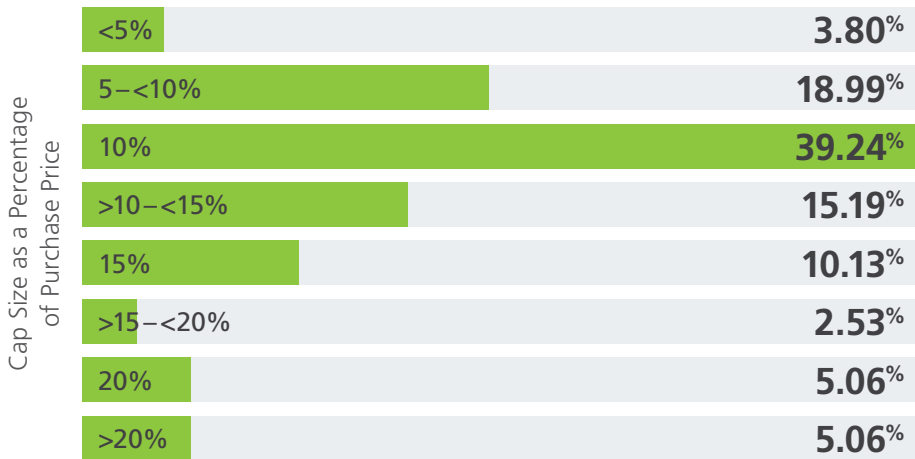
Indemnity Basket Size*



OBSERVATIONS*

- Median basket size in deals surveyed increased in 2017 to 1.0% of the purchase price (as compared to 0.75% since 2015). However, the median basket size for R&W Insured Deals was 0.5% which is consistent with our experience with R&W insurance.
- The median basket size for deals surveyed having a true deductible was 0.88% of the purchase price in 2017 (compared to 0.82% in 2016).
- The median basket size for deals surveyed having a threshold/tipping basket was 0.72% of the purchase price in 2017, an increase from 0.53% in 2016.
- We noted an increase in deals having a true deductible basket of greater than 1.5% (almost 21% as compared to 8% in 2016) and noted that a significant number of these deals (10 out of 13) involved the oil and gas industry.

Indemnity Cap Size*



Percentage of Deals Surveyed Providing for Indemnity Cap

OBSERVATIONS*

- Approximately 94% of deals surveyed had an indemnity cap.
- The median indemnity cap continues to remain unchanged since 2013 at 10%. As discussed earlier, the use of R&W insurance in a transaction typically greatly reduces the seller's indemnity cap under the purchase agreement to approximately 0.5% (of course, this is due to the fact that buyers will seek recourse under the R&W insurance policy). The median indemnity cap for the R&W Insured Deals surveyed was 1%, however this reflected a handful of deals with larger caps likely due to specific indemnity items being excluded from the R&W insurance policy coverage.
- Approximately 62% of deals surveyed had an indemnity cap of 10% or less.
- Only approximately 4% of deals surveyed had an indemnity cap of less than 5% of the purchase price while approximately 10% of deals surveyed had an indemnity cap of 20% or more of the purchase price.

Glossary

Indemnity Escrow Amount

The indemnity escrow amount is the portion of the purchase price held in escrow to serve as a fund to satisfy indemnification claims against the seller.

Indemnity Escrow Period

The indemnity escrow period is the length of time after the transaction closing date that the indemnity escrow amount is held before being released to the seller.

Representation & Warranty Survival Period

The survival period is the length of time after the transaction closing date during which a party may make claims for breaches of representations and warranties.

Carve Outs to General Survival Period

Certain specified representations and warranties may be carved out of the general survival period for representations and warranties and survive for a longer period of time.

Indemnity Basket

An indemnity basket requires a party to incur a certain amount of indemnifiable losses before it can seek indemnification from the other party. There are generally two types of baskets: **true deductibles and threshold/tipping baskets**. With a true deductible, the indemnifying party is only responsible for losses exceeding the basket amount. With a threshold/tipping basket, the indemnifying party is responsible for all losses from dollar one once a party's indemnifiable losses reach the basket amount. Indemnity baskets typically apply only to breaches of "general" representations and warranties.

Indemnity Cap

The indemnity cap limits a party's maximum liability under the indemnification provisions to a stated dollar amount. Indemnity caps typically only apply to breaches of "general" representations and warranties.

Minimizing Risk in Your M&A Transactions: What's Trending

CYBERSECURITY & GDPR



Data is the new capital asset. How a company manages this asset, and how it protects its ability to acquire more of this asset, is critical to its long-term health and value. In today's data-driven world, cyberattacks have dramatically impacted many businesses, opening the door to an array of new considerations when evaluating target companies and altering the "traditional" due diligence landscape. It isn't just cyberattacks which generate deal risk – it is also regulatory risk. What do you do when local law prohibits data usage which is critical to the value of the target?

These regulatory threats do not arise solely from the physical location of the company, but also the location of the individuals whose personal data is used by the company. European Union (EU) law regarding General Data Protection Regulation (GDPR) can now apply to companies even when they are not physically located in the EU. The GDPR imposes a whole host of administrative requirements on businesses relative to data protection programs. The absence of an effective data protection program can subject a company to up to 2% of the company's global gross revenue in administrative penalties.

When assessing target companies of all sizes, it is now a best practice to prioritize privacy and data security factors at the beginning of an M&A transaction, including thoroughly evaluating a target's cybersecurity processes and conducting a risk assessment to identify and mitigate potential threats. Ignoring this crucial step could lead to over-valuing a target, and may result in "buying a problem" that is not simply solved by collecting money damages. Reputational damage can also negatively impact the buyer's other businesses. Due diligence requests should be tailored to the target's business to specifically request information regarding the applicable privacy and data security framework, including:

- policies and practice manuals (including data maps and data classification schemas),
- details regarding any data security breaches or unauthorized use of the target's IT systems,
- information regarding claims or proceedings relating to privacy or data security,
- the results of any privacy and data security practice audits,
- employee cybersecurity training materials and testing results, and
- information regarding compliance measures with privacy and data security laws, rules and regulations and contractual requirements.

Increased emphasis should be placed on cybersecurity matters when drafting acquisition agreements, including representations and warranties, actions to be taken by the target prior to closing to rectify known issues or prevent potential future issues, and special indemnification protection and indemnity escrows by the seller related to any such issues.

Get to know Seyfarth's Global Privacy & Security (GPS) Team: www.seyfarth.com/global-privacy-security.

WAGE & HOUR LITIGATION



Wage & hour lawsuits have skyrocketed and multi-million dollar verdicts and settlements are becoming the norm, with the total value of the top 10 wage & hour settlements in 2016-2017 reaching more than \$1.2 billion. The range of industries susceptible to risk run the gamut, from restaurants and hospitality, retail, and healthcare, to companies with “tech” workers and those using non-employees. Areas of risk and common claims involve misclassification of employees as “exempt,” failure to pay overtime or provide employee benefits to independent contractors, failure to pay for time worked before or after work shifts, including on mobile devices, and failure to pay for work during meals or breaks, among others. This phenomenon can extend liability to parent companies for the acts of their subsidiaries, to franchisors for the acts of their franchisees, or to individual owners for the acts of their companies.

In the context of an M&A transaction, buyers should assess wage & hour risks during due diligence by conducting a full audit of employment practices. Typically, the audit will allow for the review of wage statements, timekeeping systems, job classifications, company policies on timekeeping and overtime, and other important documents that may uncover potential areas of concern. The acquisition agreement should be tailored to protect against identified risks, including by providing appropriate representations and warranties, pre-closing covenants to correct identified issues and for purposes of indemnification, defining “losses” to include fines for noncompliance levied by enforcement bodies, as well as all costs of bringing the target into compliance, and excepting these claims from the baskets and caps that may be included in the acquisition agreement.

Get to know Seyfarth’s Wage & Hour Litigation Team: www.seyfarth.com/wage-hour-litigation.

DISCLAIMER: The acquisition agreement provisions that form the basis of this Survey are drafted in many different ways and do not always fit precisely into particular “data point” categories. Therefore, Seyfarth Shaw LLP has had to make various judgment calls regarding how to categorize certain provisions and has rounded certain figures for ease of presentation. As a result, the conclusions presented in this Survey may be subject to important qualifications that are not expressly articulated in this Survey. The findings presented in this Survey do not necessarily reflect the views of Seyfarth Shaw. In addition, while Seyfarth Shaw gathers its data from sources it considers reliable, it does not guarantee the accuracy or completeness of the information provided within this Survey. Seyfarth Shaw makes no representations or warranties, expressed or implied, regarding the accuracy of this material.

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Seyfarth's Leading Middle-Market M&A Practice



Recognized as a leading middle-market M&A(sub-\$500m) practice by *The Legal 500* since 2012 and shortlisted for its 2015 US Practice of the Year Award in the M&A Corporate & Commercial: Mid-Market category.



U.S. News & World Report: Best Lawyers "Best Law Firms" recognized Seyfarth's Corporate Law and Mergers & Acquisitions Law practices (2017-2018).

“ Seyfarth has “a very responsive, knowledgeable, lean practice, which has lawyers who are courteous and succinct.” ”

– Client quote, *The Legal 500* (2017)

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