

Fourth Edition | Chapter 4

SECURING M&A SUCCESS
DUE DILIGENCE IN THE GLOBAL MARKETPLACE

BEST PRACTICES OF THE BEST DEALMAKERS
2016

Introduction by
David Fergusson | Editor

“In emerging markets, the cultures of the buyers and sellers can be very different. The sellers in many instances are family businesses. Their familiarity with the M&A process is generally very low. We help them a lot in preparing for the due diligence.”

– Fabio Niccheri, Partner, PwC Corporate Finance



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BEST PRACTICES OF THE BEST DEALMAKERS

Drawing on the experience and expertise of the “best in class” dealmakers, The M&A Advisor (<http://www.maadvisor.com>), together with the leading provider of virtual deal management services, Merrill Corporation (<http://www.merrillcorp.com>), publishes the quintessential dealmakers guide series – *Best Practices of the Best Dealmakers*. Profiling the proven strategies and unique experiences of the leading M&A practitioners, this series is distributed in regular installments for M&A industry professionals in both print and interactive electronic media. Previously published features and chapters are also available in the online libraries of Merrill Corporation and The M&A Advisor. We are pleased to present **Securing M&A Success: Due Diligence in the Global Marketplace**. This installment examines the Due Diligence process that unlocks the value of the deal, the writing of the Purchase Agreement (which is the most important record of the transaction), and the closing of the deal.

On the following pages, you’ll find helpful observations provided by candid interviews with leading dealmakers, including buyers, sellers and advisors, as well as timely insights into the most current trends.

INTRODUCTION

The year 2016 opened with a period of market volatility that sent shudders through markets from Shanghai to London to New York. The last quarter surge in M&A activity in 2015 – reaching a record high of \$4.6 trillion – may be difficult to top if the volatility persists throughout the year. But if past is prologue, M&A dealmakers will use this period of uncertainty to evaluate and re-tool their strategies for maximizing value in the global economy.

In the previous chapters of this 4th edition of *Best Practices of the Best Dealmakers*, we have seen that cross-border M&A has become the norm in dealmaking – accounting for nearly half of all deal values in 2015. In the following chapter, “Securing M&A Success: Due Diligence in the Global Marketplace,” The M&A Advisor examines the crucial transactional processes of due diligence and development of the purchase agreement that gets the deal to the closing. As always, we draw on the expertise of professionals from advisory to legal, accounting to investment banking, private equity to corporate. In addition, this chapter has insights from professionals in the insurance industry – which has developed rep and warranty insurance, a new product that is rapidly gaining traction in M&A (as well as spurring an interesting new career path for some M&A lawyers).

I would like to thank our esteemed M&A Advisory Faculty who shared their knowledge and advice this phase of the M&A process. They are **Fahad AlDehais**, Partner and General Manager at AlDhabaan & Partners in Saudi Arabia, in association with Eversheds; **Jeff Anderson**, Senior Vice President and leader of the North American M&A Group at Allied World Insurance Company in Atlanta, Georgia; **Adrian Balcombe**, Managing Director with Alvarez & Marsal and Head of the firm’s European Transaction Advisory Group in London; **Christoph Eppinger**, Partner at the German audit and consulting firm Ebner Stolz with responsibility for financial due diligence projects, purchase price allocations, audits and other valuations; **Charlie Johnstone**, who manages origination at ECI, a private equity house in London; **Chuck Moritt**, a Senior Partner and M&A North America Business Leader and chair of Mercer’s Global M&A Group; **Giles Murphy**, Partner in Mergers & Acquisitions and Risk Practice at JLT Specialty Limited, a global insurance and advisory services

firm based in London; **Fabio Niccheri**, Partner at PwC Corporate Finance in Sao Paulo, Brazil, who specializes in M&A transactions and valuations; **Alan Pratten**, Managing Director and Head of Major Risks, Mergers & Acquisitions and Dispute Resolution Practices for insurance brokerage Arthur J. Gallagher in London, and **Simon Rootsey**, European Counsel in Corporate and Private Equity, based in London, for international law firm Skadden.

In the next chapter of the 4th edition of *Best Practices of the Best Dealmakers*, we will be adding new perspectives from more global dealmakers on various issues that arise in the period after the closing, including regulatory reviews, integration issues, liabilities and risks, and how M&A's best practitioners strive to mitigate the risks. As always, we invite our readers to share their thoughts and observations on these topics with us for future editions.

David A. Fergusson

Editor

Best Practices of the Best Dealmakers

Securing M&A Success: Due Diligence in the Global Marketplace

Part I: Due Diligence and Its Increased Importance in Cross-Border Deals

“It’s very much about agreeing with your client upfront. You need to be very much focused on what the client needs to know, be it from an integration perspective to ticking the boxes on the financials. Clients are a lot more cost-conscious on the due diligence part of the transaction. They’re seeing that there is value in a targeted approach and it does help smooth the transaction.” – Giles Murphy, Partner in M&A and Risk Practice, JLT Specialty Limited

The robust amount of Mergers and Acquisitions activity in 2014 and 2015 has led many professionals to conclude that it is a seller’s market. If so, that only increases the importance of the due diligence process, which begins in earnest when the Letter of Intent (LOI) is completed, and concludes with the signing of the Purchase Agreement (PA). Sellers must provide a mountain of relevant data for examination by the buyer, a process that normally begins when the seller presents itself for sale. In today’s M&A market, most of this data is in electronic form and stored in secure virtual data rooms. The buyer, usually assisted with a team of lawyers, accountants and advisors, pores through the seller’s data in order to confirm the valuation of the transaction and develop an overall comfort level with the deal.

The due diligence process takes from 30 to 90 days – longer in some complex cross-border transactions. In periods of robust M&A activity such as the market has seen during this decade, the due diligence time frame has become compressed by intense competition for deals and better access to information through technology such as virtual data rooms. M&A professionals interviewed for this chapter of *The M&A Advisor’s Best Practices of the Best Dealmakers* series generally agreed that the shorter due diligence time frames bring efficiency and value to the deals and, while risks and liabilities remain, new practices – including the growing use of Rep and Warranty Insurance – are developing to mitigate them.

“Timetables are always being compressed,” says London-based Simon Rootsey, who is European Counsel in Corporate and Private Equity for international law firm Skadden. “It does put more pressure on buyers and lawyers to make

sure the due diligence is as targeted and as efficient as possible – therefore, when you're operating on an accelerated basis, it is critical that you understand the key value drivers." Rootsey and others involved in due diligence confirm that "materiality thresholds" have increased in recent years. "It's very much about agreeing with your client upfront what they want to get out of the due diligence process, be it from an integration perspective, transaction structuring or purely focused on change of control risk issues. Although clients have become a lot more cost-conscious with due diligence in recent years, they still do see real value in a targeted due diligence exercise and the manner in which it can assist in ensuring a smooth transaction."

Rootsey and others involved in due diligence confirm that "materiality thresholds" have increased in recent years. "It's very much about agreeing with your client upfront," he says. "You need to be very much focused on what the client needs to know, be it from an integration perspective to ticking the boxes on the financials. Clients are a lot more cost-conscious on the due diligence part of the transaction. They're seeing that there is value in a targeted approach and it does help smooth the transaction."

Giles Murphy, Partner in Mergers & Acquisitions and Risk Practice at JLT Specialty Limited (a global insurance and advisory services firm based in London), agrees that due diligence time constraints have led to more targeted issues for inquiry. "What are you going to look into, why?" Murphy asks. "What's the value? There's a general move to align diligence with the materiality threshold. If you have a limited period of time, you should only focus on things that could have a material impact on the deal structure. I don't waste time on things that don't have material impact."

"As a Private Equity buyer, we try and complete as much of our due diligence before final offers," says Charlie Johnstone, who manages origination at ECI, a private equity house in London. "In particular, we will commission commercial due diligence prior to a process. If there is vendor due diligence, we will ask for access early to complete as much work as possible prior to any final offer. This can reduce the length of time needed to close a deal once an LOI has been signed and reduce the uncertainty for a seller." In cross-border deals, Johnstone says, "It just takes more time due to different time zones and even if you try and do everything in-person there are still many meetings that need to be done via video conference which are less effective. Patience... and a high degree of emotional intelligence [is necessary] to try and understand the other party's viewpoint, even if it clashes with the norms in your own country."

Fahad AlDehais, Partner and the General Manager at AlDhabaan & Partners in Saudi Arabia, in association with London-based law firm Eversheds, says due diligence time compression has put more pressure on buyers. “Buyers are looking absolutely at the issues that could kill or close the deal. The investor comes to us and says he’s interested in that company but he doesn’t know it. You only have two weeks – come back and tell me why I should not invest in this company,” AlDehais says. “It’s good for the lawyers, but it’s bad for the buyers and sellers because they don’t have enough time to evaluate.” He added that because of the tight time frames, travel has lessened. “We don’t have the luxury and rely almost 100 percent of the time on communication from the target. Issues come up. That’s why I don’t like 100 percent reliance on virtual data. Sometimes you need to go and see of the other management and determine if they are genuine.” Due diligence on deals within Saudi Arabia, he says, can be done realistically in two weeks. Cross-border transactions take more time. “In Saudi to Dubai, two weeks is unrealistic. You need to determine whether the documents are genuine, and that takes time.”

“Yes, time frames are compressed but there are still lots of transactions that don’t follow a compressed process,” says Adrian Balcombe, Managing Director with Alvarez & Marsal and Head of the firm’s European Transaction Advisory Group in London. “There are a lot of outliers these days – it may be a distressed situation or other special circumstance.” But he added time compression is good for sellers “if the sell side has organized themselves... there are a large community of buyers out there. But the sellers and their advisors are able to run a most aggressive process with limited time, limited access and control the process themselves. They can force buyers into a contract race.” Balcombe, who has advised on M&A for 23 years and approximately 400 deals, added: “Ten or 15 years ago you had long exclusivity periods but that’s not so much the case now.”

“It’s a seller’s market. Sellers know that,” says Chuck Moritt, Senior Partner and M&A North America Business Leader for MMC and chair of Mercer’s Global M&A Group. Moritt says sellers today are “putting in less data. We have to distinguish between an auction and a friendly deal. An auction situation is very controlled by the seller. Auctions have shorter time frames and less data. They require sellers and buyers to basically take on potentially more risk in valuation methodology.” Moritt, who generally advised in the human resources area of due diligence, says in cross-border situations he characterizes risk differently depending on countries and regions. As an example, he says a

“It’s a seller’s market. Sellers know that... We have to distinguish between an auction and a friendly deal. An auction situation is very controlled by the seller. Auctions have shorter time frames and less data. They require sellers and buyers to basically take on potentially more risk in valuation methodology.”
– Chuck Moritt, Senior Partner, Mercer

US company looking to acquire across borders faces higher risks in countries with stricter labor laws, such as France or Brazil: “So part of diligence isn’t just doing the financial review; fundamentally it’s about the future state operational view and what’s the business going to look like when I’m the new owner. If I do diligence with that in mind, it will be captured in the purchase agreement.”

Fabio Niccheri is Partner at PwC Corporate Finance in Sao Paulo, Brazil, working on M&A transactions and valuations. “Today in Brazil, around 40 to 50 percent of deals include a foreign party,” Niccheri says. “In emerging markets, the cultures of the buyers and sellers can be very different. The sellers in many instances are family businesses. Their familiarity with the M&A process is generally very low. We help them a lot in preparing for the due diligence.” He says the due diligence process in Brazil can be much more complex than in a typical deal in the US or the UK. “We still actually find many physical data rooms in Brazil for example. It’s very common that foreign buyers are concerned and dig a lot into financial numbers, whether there are contingencies or not, taxes and labor. I have seen transactions that have closed but buyers later on did not realize the full value of what they paid because they spent 95 percent of the due diligence on financials and 5 percent on how the business will do going forward. When you do due diligence you need to understand how the company will operate after the deal is completed.”

Christoph Eppinger is Partner at the German audit and consulting firm Ebner Stolz, with responsibility for financial due diligence projects, purchase price allocations, audits and other valuations. Much of his due diligence work is on deals between German companies and counterparties in the US, UK, the Netherlands, China, and Italy. “You have pressure on the time frame for every process, cross-border or domestic,” Eppinger says. “It’s even more pressure for the auction process.” As a best practice, he recommends that buyers ask that data collection is done before due diligence process begins. “The seller should

have data room already in place and can open it as soon as the LOI is signed,” he says. “You just have to react in a shorter time frame. Decisions may be made on a weaker basis. Maybe the buyer has to accept not having the whole picture for all the details because the situation is very competitive.”

He also says the due diligence time frames are not very different in his cross-border transactions. “When we are doing the due diligence in [the US], we will be managing with the local expertise of partner firms but it’s important that we are on-site. So it’s a joint project with our colleagues. The local people are needed for local tax or text issues. It’s not only a matter of local expertise, but also culture and language. It’s very helpful having local people who can help with that.”

DEAL NOTES

Due Diligence – View From An Active Acquirer

One company for which Eppinger has advised on deals is Colfax Corporation, a diversified global manufacturing and engineering company based in Maryland. Daniel A. Pryor is Executive Vice President, Strategy & Business Development, at Colfax. “We’re a fairly active acquirer. We’ve done 17 deals in the past three years,” Pryor says. “We bought a company about five times our size in 2012 – with a rather complicated structure. But most of our deals are add-ons to our existing portfolio and have synergy with what we do.

“We divide diligence into a handful of pieces,” Pryor says. “There are three things you’re doing: One, confirming value; two, identifying risk that you need to share and could have a value impact, and three, preparing for integration. The value part – one piece is top-line related. How do we get comfortable? Another piece is cost related – do we believe the costs aren’t going to change dramatically or is something abnormal about the past couple of years? What are the synergies we’re going to get? We need to confirm the value. The risk part is a lot more mechanical – data requests. It’s largely driven by legal, environmental and tax issues. The main challenge there is figuring out what your exposures are and how you can address them contractually.”

Pryor said country-specific risks are always present and sometimes cannot be foreseen during due diligence. “You may be doing the analysis based on incomplete information and there’s always something you don’t know.” As an example, he cited a company that Colfax acquired in France with a plant that

was set to be shut down after the deal closed. “We thought we had a conservative model. Then the administration in France changed, and the labor laws changed, and [it turned out to take] a bit longer than we thought.”

Part II: Liabilities, Contingencies, Reps and Warranties: How to Protect

“Getting the parties to accept the purchase price agreements and the reps and warranties, it’s helpful having a strong lawyer on your team who is in communication with the buyer or seller. As an auditor, you can be more in the background and for the critical issues you may come with your own opinion. Each needs the critical guidance.” – Christoph Eppinger, Partner, Ebner Stolz

Striking a balance between an efficient and cost-effective due diligence process and limiting post-closing liabilities and risks is a peculiar part of the deal-making process. “There’s always a tension between parties wanting to underplay or overplay how much diligence has been done. There tends to be the devil in the details,” says Skadden’s Simon Rootsey. “Some parties always take a bullish view and it can be slightly too bullish and things can come out of the woodwork. We try to get the right balance by saying how much you’ve actually done.”

Mercer’s Chuck Moritt says it’s critical to “make sure the deal strategy and business strategy aligns.” Due diligence on the financial aspects of the deal is important, he says, adding that the operational “to be” ultimately influences the price. By “to be”, he means the terms and conditions captured in the Purchase Agreement that will affect the combined entity after the deal closes. “The ‘to be’ is what influences ultimately the price I want to pay, the price I’m willing to pay,” he says. “It’s the terms and conditions, like benefit continuity, seller obligations for transitioning support and things of that nature. I don’t know if enough sellers spend enough time on that operational ‘to be’ than on the financials.” In cross-border M&A, Moritt says, due diligence can be very different depending on the number of countries involved. In a deal involving multiple countries, the strategy should be to segment the due diligence on the perceived risks in the various jurisdictions. “The focus should be on the higher-risk countries. The medium-risk countries may move the needle, and the low-risk countries are unlikely to move the needle, so there’s no reason

to spend a lot of time on things that don't provide significant impact during diligence.”

Fahad AlDehais says that as a best practice, “We submit a list of the issues to the client and the client goes and discusses whether there are material issues with the seller. On the sellers' side, it's the other way around... The sellers most of the time submit less material documents so they can extend the negotiation as much as possible and have the upper hand.”

In Brazil, PwC's Fabio Niccheri says, the negotiation of the purchase price and the amount to be put into an escrow account is one of the most critical pieces of the due diligence process. “I have seen buyers discussing 50 percent or more going into an escrow,” he says. “Some sellers will never accept that much. The lack of information in many cases can be an issue. Many companies are not fully prepared and don't have all the records or have them organized to be analyzed in due diligence process. So gathering information is a hurdle.” Niccheri said one due diligence process he worked on took several months, with new information “going into the data room on a daily basis. Some critical information took months to get.” But, he added, that case was exceptional and most processes do go much smoother.

Ebner Stolz's Christoph Eppinger says cutting through cultural and language issues to get parties to accept the ultimate purchase price is a real challenge in cross-border due diligence. “Getting the parties to accept the purchase price agreements and the reps and warranties, it's helpful having a strong lawyer on your team who is in communication with the buyer or seller. As an auditor, you can be more in the background and for the critical issues you may come with your own opinion. Each needs the critical guidance.”

“From an advisor perspective, it is really all about the information. The quality of the information is key. Without that you can't do your job,” adds JLT's Giles Murphy. “There needs to be real engagement from the seller from whichever territory it's in. The information needs to be given within a decent timeframe to allow you to do your analysis, synthesize your information and feed it back to your clients. Some transactions that have been in the hopper for a long time and the relationship between buyer and seller may be very good. Those deals tend to be smoother than deals where there is a bidding auction. There the level of trust might be so great and the parties have to go back and ask for more information.” In cross-border deals with multiple parties involved,

“We see some foreign buyers come in, and because of the aversion to risk in the UK and US and our legal system here, we do see some foreign buyers buy Rep and Warranty policies when they introduce themselves to the American marketplace.”

– Jeff Anderson, Senior Vice President, Allied World Insurance Company

Murphy says sellers can be challenged by supplying information to multiple bidders. “That improves markedly once two parties have agreed on the preliminary terms of the transaction,” he notes.

Striking a balance between an efficient and cost-effective due diligence process and limiting post-closing liabilities and risks is a peculiar part of the deal-making process. “At the outset of a transaction (particularly at the indicative offer / bidding stage), there’s always a tension between bidders wanting to overplay how much diligence has been done. There tends to be the devil in the detail of the oft used phrase ‘confirmatory due diligence’ only remaining,” says Skadden’s Simon Rootsey. “Irrespective of whether a client is taking a bullish view of the level of due diligence that they have completed at the offer stage, it does generally help the sell-side by providing a list of any “confirmatory due diligence” items or areas that is as specific as possible to try to avoid the inevitable follow-up questions. It is trite to say that being upfront with how much work has been actually done is generally the best approach (particularly given the sell-side will generally have their own view on where a bidder is in the due diligence process based on the level of VDR use, approach to Q&A and interactions with management).”

Adrian Balcombe of Alvarez & Marsal in London notes that the “locked box” transactions have become more common recently in the U.K. in cross-border deals. “In the old days you would buy a business based on the documents,” he says. “In a locked box transaction, you are buying based on what the parties expect the stock to be worth at the point where you buy the business. The seller will sell without any further recourse. This means for the buy side you have to be very certain on what you’re buying and paying, and more diligence is required pre-signing.” He added that the locked box mechanism “was instigated in the U.K. and is now used more widely, but we’re still seeing a number of bidders from other parts of the world, including the U.S. who are not familiar with the process.”

Prior to the current decade, virtually all M&A deals closed with explicit disclosures of liabilities and risks that could occur after the closing. But during the current decade a new product from the insurance industry – Rep and Warranty Insurance – has begun to see more widespread use among dealmakers.

Jeff Anderson, Senior Vice President at Allied World Insurance Company leads the North American Mergers & Acquisition Group from Atlanta, Georgia. He said the use of Rep and Warranty insurance in the North American market has “really taken off in the last three to four years.” Reasons include reductions in insurance premiums, which generally run under 5 percent of a policy’s face value, to increase usage and competition to market the product by underwriters. “We’re one of the very few companies with a global reach in these policies,” Anderson says, “but we choose to stay away from certain areas as well, like Russia for instance. We see some foreign buyers come in, and because of the aversion to risk in the UK and US and our legal system here, we do see some foreign buyers buy Rep and Warranty policies when they introduce themselves to the American marketplace.”

In the UK, Alan Pratten is Managing Director and Head of Major Risks, Mergers & Acquisitions and Dispute Resolution Practices for insurance brokerage Arthur J. Gallagher, which also writes Rep and Warranty policies. He says the product is particularly used by private equity firms in deals that are medium to large in size. “It’s becoming very common in private equity. I can’t say exactly, but my gut says it’s about 60 percent of those deals. That’s not true of large corporate transactions.” Pratten says many dealmakers are becoming more comfortable on the scope of the policies, recognize the limits of due diligence and are discovering how insurance can help deliver the deals within the tight timeframe. “Whereas two lawyers might have argued forever, now insurers can add a real dynamic,” he notes. “Insurance is filling the gap between where the buyer and seller want to be limit-wise and time-wise.”

Along with the trend toward increased usage of Rep and Warranty insurance is a trend noticed in both the UK and US markets: M&A attorneys jumping from law firms to insurance. “Today, 99 percent (of Rep and Warranty brokers) are M&A lawyers jumped over to insurance land,” Pratten says. Jeff Anderson and Giles Murphy also confirmed the lawyer-to-insurance broker trend. “When the product was launched, it was traditional insurance underwriters,” Murphy said. “These days, many insurance businesses are led and staffed by an

abundance of M&A lawyers. It's also given comfort to legal firms when they're working with people who they know and respect."

Murphy says JLT traditionally was used for M&A advisory, but adds: "Now, 50 percent of the time, we're advising and doing Rep and Warranty policies. Five to 10 years ago nobody heard of it; now it's on every checklist." Murphy said the insurance is now beginning to spread beyond the UK and US into more cross-border deals. "The growth is a natural maturity process and involves the education of deal professionals. They understand it better and are less afraid of it, so the momentum builds. But the bigger reason – a flood of extra capacity that has come into the market in terms of insurers which has driven down prices and made it much more attractive."

DEAL NOTES

Uses of Rep and Warranty Insurance

According to JLT Specialty Limited, a global insurance and advisory services firm based in London, following are the top five uses for Rep and Warranty Insurance:

- Use by seller to ring-fence liability and gain a clean exit without having to tie up sale proceeds (particularly in the case of financial sellers)
- As a bid differentiator in an auction process
- To back a deal where the long term solvency of the seller is in question
- Where selling shareholders are retiring and wish to secure proceeds
- In cross border deals

Other Scenarios may include:

- To wrap historic liabilities when a fund is winding down or a business is being liquidated
- In escrow replacement
- To bridge general warranty gap concerns (financial and time)
- To avoid pursuing the management team
- To remove specific deal deadlocks – e.g. potential tax or litigation liabilities

In a recent case study provided by JLT, an Asia-Pacific trading house was selling an Australian subsidiary in a \$600 million deal. The seller was retaining \$600 million

in liability, which was an unattractive long-term balance sheet item particularly given the seller's public ownership. As a solution, JLT placed a significant seller policy limit to enable the client to ring-fence a substantial part of this liability.

In another case, a UK construction company was buying a £20 million UK building company from a private equity house and its management team. The PE house was not willing to give warranties. The warranty cap was limited to management's equity which was £200,000. The buyer wanted a £10 million warranty cap. JLT's solution was to write and put in place a £10 million buyer-side policy for £100,000 + tax and fees.

Part III. The Importance of the Purchase Agreement

“It's the legal document where everything has to be fixed. It fixes the terms and conditions for buying or selling, the purchase price – in most cases we see an adjusted purchase price. After the purchase agreement is signed there are important other documents – but everything should be fixed in the purchase agreement.” – Christoph Eppinger, Partner, Ebner Stolz

Working on a parallel path with the due diligence process is the drafting and marking-up of the Purchase Agreement. It is the formal legal document that defines and stipulates all of the critical terms and conditions of the deal, including the purchase price, post-closing agreements and identification of post-closing risks and liabilities. Although most documents in the M&A process are non-binding (unenforceable in a court of law), the purchase agreement is a formal, enforceable legal document – the most important document in the entire deal process. As discussed in the previous chapter (**The Global Courtship: Steering a Cross-Border Deal to the LOI**), the Letter of Intent is often compared to a proposal, and the purchase agreement is likened to a wedding license.

“It's the legal document where everything has to be fixed,” says Christoph Eppinger of Ebner Stolz. “It fixes the terms and conditions for buying or selling, the purchase price – in most cases we see an adjusted purchase price. After the purchase agreement is signed there are important other documents – but everything should be fixed in the purchase agreement.” Eppinger and other M&A professionals interviewed here say typically the seller presents the first draft of the purchase agreement and through negotiations and mark-ups the parties come to a common understanding. Adjustments to the

purchase agreement may occur when parties have different understandings of different clauses in the agreement. Though rare, some cases end up in disputes over terms in the purchase agreement and end up in court. “If the parties disagree after signing they need to talk and try to solve the problems through amendments or they may need to bring in a third party to help solve it,” Eppinger says.

The results of due diligence and the critical twists that it can create comes up at various stages during the transaction process, according to Skadden’s Simon Rootsey who flags the following insurances: (i) during any exclusivity period (“Generally, bidders will need to provide weekly confirmations that it is still prepared to do the deal on the same terms set out in its previous offer. As a result, bidders need to quickly understand and analyze any key due diligence findings that go to price or material deal terms before providing such timely confirmations); (ii) the first mark-up of the Purchase Agreement (“There is the obvious tension between reserving your position for issues that might come out of due diligence (particularly when the Purchase Agreement is being negotiated whilst “confirmatory due diligence” is being completed) and not wanting to create issues that do not exist “just because something might come out”), and (iii) the first draft of the specific disclosures in a UK style disclosure letter. “In the U.K., a disclosure letter makes specific factual disclosures regarding the manner in which a warranty is untrue,” Rootsey says. “Invariably you will be thrown a few curve balls as people tend to be more inclusive about what they disclose against the warranties than what they might have disclosed in the data room or during Q&A / management presentations given the risk of liabilities for breach of the warranties. Whilst you hope that it doesn’t happen and that due diligence has caught all material issues, it is not uncommon for things to come out of the woodwork at this late stage and you start having those awkward discussions around price, indemnities, escrow or some other form of protection if they are sufficient material.”

Fahad AlDehais of the Saudi law firm AlDhabaan & Partners says the purchase agreement is an insurance policy, “in the sense that it puts down their liabilities, indemnities, etcetera for all the shareholders. It’s an exchange of assurances.” Similar to the twists and turns in the due diligence process, AlDehais says, “Once it goes into the purchase agreement, anything can be used as bargaining chips.” But, he adds, due diligence and drafting the purchase agreement are “two different processes, and they’re not conflicting. The more parties involved, the more complicated the agreements can

“The way to get to those disclosures is through the diligence. The two processes are by necessity intertwined and there’s an alignment between the two.” – Giles Murphy, Partner in M&A and Risk Practice, JLT Specialty Limited

become. If you have an investment banker, advisor, commercial counselor and lawyer involved, the most effective way is to have the lawyer working on the document and everybody else just commenting. We try to incorporate as much as possible nothing that is contentious so that the agreement is ongoing. By the cut-off time, all of these issues are resolved and the company can be confident that the agreement will succeed.”

ECI Partners’ Charlie Johnstone agrees on the necessity of the parallel courses of due diligence and drafting the purchase agreement. “Yes, we will often look to mark up a sale and purchase agreement prior to final offers and signing a LOI. This helps to reduce uncertainty and get any issues out on the table early,” Johnstone says.

JLT’s Giles Murphy sees the seller’s disclosure letter, delivered to the buyer concurrent with the purchase agreement, as another key document. “The main driver for diligence is to elicit disclosure from the seller,” Murphy says. “The disclosure letter is the key document that attaches to the purchase agreement. It sets any exceptions, such as environmental issues, insurance claims. The way to get to those disclosures is through the diligence. The two processes are by necessity intertwined and there’s an alignment between the two.”

A good purchase agreement, says Mercer’s Chuck Moritt, will have a very detailed “employees matters” agreement. “It will be very detailed on how employees are going to be treated after the closing. Depending on the dynamic of whether it’s a stock or asset sale, it will dictate what kinds of consultations you have to have with unions, what the regulatory issues are with regard to employees.” Moritt notes that because Western Europe has a particularly “difficult labor regulatory environment, the stock or asset sale aspect has material impact.”

In Brazil, PwC’s Fabio Niccheri says, the practice is for the purchase agreement to define a number of important issues beyond the purchase price, citing as an example the rules for non-competition. “What is the responsibility of

the partners if you have more than one shareholder remaining? What is the amount of the escrow account?” he asks. “These all have to be defined before the purchase agreement can be signed. At the end of the day what you find in the due diligence process has to be reflected in the purchase agreement. If you develop the purchase agreement and then find in due diligence that it should be rewritten – it should be adjusted so there’s no conflict between the two. The PA should reflect everything. It’s often 50 to 100 pages and contains lists of clients, products, assets, labor claims, et cetera.”

Adrian Balcombe of Alvarez & Marsal in London adds that “In the old days a company would hire you for due diligence and you would go off for several weeks and work in isolation. Because of lack of time, these days there’s much more focus on the development of the purchase agreement. That’s where your diligence should be focused. It’s a lot more coordinated effort now. It’s just more sophisticated.”

DEAL NOTES

Drivers of Deal Success in Global M&A: Navigating Human Capital Risks Across Borders

In 2014, Duncan Smithson, Chuck Moritt and Jeff Cox of Mercer published an essay in *The M&A Journal* entitled *Drivers of Deal Success in Global M&A: Navigating Human Capital Risks Across Borders*, which focused on human resources issues in cross-border M&A. Following are excerpts:

“...Managing the risks of people integration alone is a highly specialized niche, subject to myriad cross-border nuances and complexities. Companies that understand these unique challenges, and develop clear strategies to address them, will be poised to capitalize on resurging global M&A opportunities and drive deal success. This applies not only during due diligence, which is the first step in identifying all of the issues a buyer/operator will confront post-deal, but also during the post-signing and post-closing integration, which is when most deals are won or lost...”

“Most companies are very familiar with the technical aspects of managing people in their own country and have reliable processes for dealing with a relatively finite set of issues. Those companies face a steep learning curve in addressing the same issues elsewhere in the world, and the complexities grow exponentially

when dealing with multiple issues across multiple countries... Unlike US employers, companies in most other countries are legally required to provide workers at all levels with contracts that define the specific terms and conditions of their employment. Often these conditions are guaranteed and must transfer to the buyer. However, if the buyer is unwilling to take on the terms of a contract, protracted negotiations or possibly firings may result, in turn necessitating the management of numerous details around severance and restructuring. Organized representation of workers varies widely around the world as well. Every Brazilian employee — white- and blue-collar alike — belongs to a union; in Italy, every worker is subject to a collective bargaining agreement; and certain European countries have works councils — local- or site-specific negotiating bodies that represent employees' interests and are quite powerful. In fact, a German company needs only five employees to form a works council, and management cannot make far-reaching decisions about structure or operations without the agreement of this body....”

“Culture greatly affects how information is gathered, how comprehensive it is, and how what is said and done is received and interpreted. With multinational transactions, these issues multiply exponentially, making the deal much more challenging and potentially problematic. Ironically, many companies are so focused on the financial aspects of the deal that culture is never really addressed. Headlines in the past decade about such failed high-profile deals as Alcatel/Lucent or Hewlett-Packard/Palm bear out culture's importance....”

“To be successful, companies need HR knowledge and expertise both at a strategic level to guide the buyer through the transaction, and at a boots-on-the-ground level to navigate the challenges and pitfalls of global transactions. In addition, they must be willing to invest in dedicated project management — a value-added skill that takes time, money, and resources, and is essential to the high degree of coordination required for complex multinational deals. Beyond a mastery of the technical aspects, companies must have resources that can cope with different languages and times zones. And they need experts who understand that a deal timeline that expects a US-centric level of data and responsiveness at all times will invariably get derailed. As the environment for cross-border deals continues to improve, companies that have deep knowledge of countries' unique operations and cultures, a clearly defined global strategy, and proven expertise in executing complex multinational transactions will be well-positioned to capitalize on worldwide M&A growth opportunities.”

Part IV. The Close: the Beginning of the End

“As a buyer we would always want in-person closings as there is always something that comes up late in the day and needs the senior principals on both sides to agree solutions.” – Charlie Johnstone, Origination Partner, ECI Partners

The proof, of course, will be in the pudding when any M&A deal closes. The post-closing period – it could be 100 days or much longer – is the proving time for the value of the deal. This is when unforeseen issues or non-disclosure could arise, potentially sending the buyer and seller back to the negotiating table – or in the worst case, into a courtroom. It’s also when external market forces may change the business landscape for the new company. Employees, customers and/or suppliers may demand new contracts. According to most of the M&A experts who were interviewed for this chapter, management changes, employee attitudes, and work performance present some of the biggest risks of all to souring all the strategy, synergy, diligence, negotiation, and goodwill from the deal’s closing.

Notwithstanding the post-closing risks, the culmination of a deal is celebratory in most instances. These days many closings involve a simultaneous signing and closing that can be advantageous to both parties because it eliminates transaction risks – such as a natural disaster or loss of key customers – during the intervening period. A simultaneous closing can save time and eliminate the need for lengthy negotiations over who should bear the risk of such events. However, a simultaneous closing may not be possible when a deal is conditioned on obtaining buyer financing, third-party or shareholder approval, or subject to regulatory review.

Skadden’s Simon Rootsey, in London, says many of the deals he works on contain a regulatory condition of an anti-trust provision that needs to be satisfied between the signing and the closing. “Where there is a gap due to regulatory conditions precedent or otherwise (for example, for buy-side funding requirements), the main discussion is who bears that risk.” In cross-border M&A, he said, “it is therefore key to understand which party is responsible for the need for a gap between signing and completion (or whether it is unavoidable because it is a mandatory suspensory regulatory or anti-trust approval), how long the likely gap will be and whether any substantive issues are expected with satisfying any of the conditions precedent.” As far as in-person or virtual closings, Rootsey says the trend is toward virtual. “It’s more

efficient, especially with more people and jurisdictions involved. Also, on cross-border deals, there is some sensitivity around where certain documents are signed and closing occurs – this needs to be taken into account when determining approach to closing (including location).” As an example of a cross-border closing glitch that can happen, he cited a deal in which a bank had issued a confirmation of a wired money transfer between buyer and seller, but in reality the funds had only moved internally between the banks’ own accounts. “In those kinds of situations you really need to have contacts with the back offices to make sure that the money can be appropriately tracked through,” he says.

As far as in-person or virtual closings, Rootsey says the trend is toward virtual. “It’s more efficient, especially with more people and jurisdictions involved. Particularly in UK when doing cross-border, some sensitivity you need to be aware of and sometimes helps to have a physical closing.” As an example of a cross-border closing glitch, he cited a deal in which a bank had issued a confirmation of a wired money transfer between buyer and seller, but in reality the funds had only moved internally between the buyer’s accounts. “In those kinds of situations you really need to have contacts with the back offices to make sure that the money can be appropriately tracked through,” he says.

ECI Partners’ Charlie Johnstone, also in London, adds: “As a buyer, we would always want in-person closings as there is always something that comes up late in the day and needs the senior principals on both sides to agree on solutions.”

“I’m not really sure whether in-person or virtual makes a difference,” says Adrian Balcombe of Alvarez & Marsal in London. “It’s quite rare in cross-border to see simultaneous closing. There’s usually a gap between the regulatory clearance or competition clearance – often causing a delay between signing and closing. They drag on as a consequence – it can be one month or it can be 12 months. In some cases, the conditions of the deal aren’t met and the deal falls away. You rely on Management during that period to carry on the business based on the forecast they’ve given you, but the risk remains with the buyer until the deal finally closes.”

Fahad AlDehais of Saudi law firm AlDhabaan & Partners notes that most closings in the Kingdom are face-to-face. “I’ve never seen a virtual closing here. And all of the international firms have some presence in Dubai, so you always have somebody on the ground.”

“I would say in most situations you don’t get to the closing table unless these issues are already resolved. Then it’s just executing the document and exchanging money. Frankly the closing, while unceremonious, is certainly emblematic of the strategy and work that went into the deal.” – Chuck Moritt, Senior Partner, Mercer

“If you can fix the signing and closing simultaneously, you remove risk that [the] seller takes cash or assets out of the firm, which might harm the buyer,” says Christoph Eppinger of Ebner Stolz. “But you typically need some time.” He says that in some cross-border deals, it is impossible to close simultaneously. “For the Chinese, it’s very important getting state authority approval. If they don’t get it, it breaks the deal. So in all cases there will be a closing item that the state must approve.” Eppinger also recommends that a single comprehensive report be prepared to go along with the closing documents in cross-border deals. “For cross-border due diligence, clients may benefit from getting one report covering all the different countries, subsidiaries, et cetera. In that case, we are the single point of contact. Clients want to have it as easy as possible and don’t want to have to spend a large amount of time managing and coordinating the project. For example, our clients only receive invoices from one party.” He recommends in-person closings as opposed to virtual closings. “In Germany, you have to be in a notary’s office. The reliability of the deal may be better if people are coming together. It helps avoiding misunderstandings,” he said.

Mercer’s Chuck Moritt advocates simultaneous closings if there are no regulatory issues involved. In cross-border deals, however, he says regulatory reviews can take up to a year, although thirty days to six months is closer to the norm. “During that prolonged period, the parties can do integration. The deals I work on mostly non-simultaneous. There are regulatory risks but companies look to mitigate that risk, citing the SAB Miller/ANB Inbev mega-merger in the distilled spirits industry, where both parties in the cross-border deal made prior arrangements to spin-off divisions and/or brands prior to the anti-trust reviews. Moritt adds: “I would say in most situations you don’t get to the closing table unless these issues are already resolved. Then it’s just executing the document and exchanging money. Frankly the closing, while unceremonious, is certainly emblematic of the strategy and work that went into the deal.”

JLT's Giles Murphy says that firms using Rep and Warranty insurance in their purchase agreements have to be certain that it's ready to be accepted by all parties at closing. "It's absolutely critical," Murphy says. "You don't want to sign the documents until that's in place." In cross-border deals, he said, Rep and Warranty policies are "not specifically aligned to closing but by the nature of cross border it is about understanding and managing the complexity of those deals. There are insurance laws in each territory and [distinct cultural] nuances. There are issues of insurance capacity. Getting a balance in what is comfortable on the local level – and how it benchmarks to a London or New York market level – is crucial."

In Brazil, PwC's Fabio Niccheri says, "It is always like to have simultaneous closings. You avoid situations where the deal is not closed and you have to announce to the market. When it's not possible is when you need shareholder or government approval." In Brazil, he says, a deal in the health care industry needs approval from the National Health Department. A deal in the banking sector needs Central Bank approval. "The gap can be from two to four months in many cases," he said. In addition to regulatory approvals, he says Brazilian companies involved in cross-border transactions "need to have exchange rates in mind. You need to send money from one country to another. If the exchange rates change dramatically, you need to have a plan to deal with the increased or decreased value of the deal." Niccheri adds that in-person closings are the norm in Brazil. "I have never been in a virtual closing."

Conclusion

The due diligence process sometimes precedes the Letter of Intent and always begins in earnest at the signing of the LOI. It runs on a parallel course with the drafting of the purchase agreement, which is the most significant and legally binding document in the M&A transaction process. Due diligence is crucial to verifying that the data and other information transmitted from the seller to the buyer is accurate. It can affect the valuation of the deal if material discrepancies turn up. Due diligence has increased importance in cross-border deals where cultural, regulatory and language obstacles come into play. Competition for deals has put pressure on dealmakers to reduce the timeframes for due diligence. Industry professionals see some disadvantages to this but in general see deal time compression bringing efficiency and cost-effectiveness to the process of M&A. In this decade a new product – Rep and Warranty Insurance – has grown in size and significance, helping fill a need left by due diligence time compression. Premiums on Rep and Warranty insurance have also decreased due to its increased usage, additional industry capacity and competition. The signing and closing of the deal are significant events in the M&A process – but it isn't over yet. The post-closing period, which will be addressed in Chapter 5 of this fourth edition of *Best Practices of the Best Dealmakers*, brings new issues, concerns and methods of mitigation into that final period before the deal is truly done.

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Adrian Balcombe is a Managing Director with Alvarez & Marsal and is Head of the firm's European Transaction Advisory Group based in London. He specializes in providing financial and related due diligence advisory services to private equity sponsors, debt providers, management and corporates, helping to create value throughout the transaction lifecycle. With more than 23 years of private equity transaction services experience, Adrian has worked with companies across a range of industries, including leisure, business services, retail, healthcare, aviation and transport, manufacturing and chemicals. He has advised on numerous private equity and bank-led transactions, mid-market and large cross-border LBOs, both buy-side and sell-side. Prior to joining A&M, Mr. Balcombe was a Private Equity Transaction Services Partner at Deloitte in London and was instrumental in building this practice between 1997 and 2008. Previously, he qualified as a Chartered Accountant and worked at KPMG from 1989 to 1996, first within the Audit practice, and later forming the first dedicated PE Transaction Services practice in 1993.



Christoph Eppinger is Partner at the German audit and consulting firm Ebner Stolz with responsibility for financial due diligence projects, purchase price allocations, audits and other valuations. He specializes in cross-border transactions and has 13 years of auditing and corporate finance experience. He is a certified German accountant and auditor, and a member of the Center of Competence International Accounting, as well as an ACA certified chartered accountant and qualified auditor in the United Kingdom. Recent M&A projects he has advised on include the acquisition of ESG (an Airbus business unit) by Armira Partners, the acquisition of Berkenhoff GmbH by the Powerway Group; the acquisition of BST, USA by DEKRA, the acquisition of Alete by BWK from Nestlé, and a special audit according to stock corporation law of Hypo Real Estate.



Charlie Johnstone is Origination Partner at ECI, a private equity house in London that invests in companies valued between £20 million and £150 million. He joined ECI in 2004, having previously worked at Ernst & Young in London for eight years, spending time in corporate finance, corporate recovery and a year with VSO. He is a frequent judge at business awards including the National Business Awards, Growing Business Awards, UK Tech Awards and the BVCA Management Awards. Established in 1976, ECI has invested in more than 250 companies helping to build many successful businesses, including Café Rouge, Chubb, Racal Acoustics, Bloomsbury Publishing, Laterooms, National Computing Centre, National Express and CarTrawler. ECI's team has more than 200 years of investment experience and a large global network. The firm invests in management buyouts, buyins and acquisition finance deals of growth companies across key sectors.



Chuck Moritt is a Senior Partner at Mercer, and serves as M&A North America Business Leader, leads MMC's M&A Advantage for M&A and chairs Mercer's Global M&A Group. As a market business leader and senior advisor, he is responsible for managing domestic and global consulting assignments such as serving as executive team adviser on integration and divestiture planning and implementation. Mr. Moritt has extensive experience in large-scale corporate transactions and specializes in human capital requirements during M&A transactions in the technology, pharma, and finance/insurance industries. He has published an number of articles on M&A Best Practices, Culture, Talent Assessment and Divestiture approaches and considerations. He has been with Mercer since 1989, and holds a BA degree from University College at the University of Maryland in general business.



Giles Murphy is Partner in Mergers & Acquisitions and Risk Practice at JLT Specialty Limited, a global insurance and advisory services firm based in London. He has worked in the insurance M&A market for 13 years advising on more than 600 transactions. These transactions have frequently had an international cross-border focus, giving him the experience and knowledge of advising on all insurable risk issues ranging from fundraising, executing transactions, and driving value from portfolio investments. A specialist in the provision of insurance and risk management advice to both the private equity and corporate sectors, he spent 11 years at Aon contributing to increasing practice group revenues four-fold between 2002 – 2007 and growing a European team to in excess of 40 dedicated staff. In 2013 Mr. Murphy moved to JLT to lead its foray into the private equity M&A sector and establishing a dedicated due diligence resource in London.



Fabio Niccheri is Partner at PwC Corporate Finance in Sao Paulo, Brazil, working on M&A transactions and valuations. Fabio joined PwC in 1988 and became partner in 1998, working in the Corporate Finance group throughout his career. He's also worked in New York with the US-Brazil Business Center, coordinating advisory services to US companies expanding into Brazil and Brazilian companies expanding to or operating in the US market. He's worked with Brazilian family businesses, Brazilian public companies, and multinational companies from the Western and Eastern hemispheres. His professional experience comprises engagements for Brazilian and multinational companies including the execution of M&A transactions in several industries; the execution and supervision of business enterprise valuation projects; development and review of intangible assets valuations, and coordination of advisory engagements in connection with US companies expanding into Latin America, mainly Brazil. He holds a Bachelor of Business Administration from Fundação Getúlio Vargas.



Alan Pratten is Managing Director and Head of Major Risks, Mergers & Acquisitions and Dispute Resolution Practices for insurance brokerage Arthur J. Gallagher in London. Gallagher operates in 50 countries with premium throughput of \$16 billion per annum. His practice is focused on businesses/issues that have difficult challenging and complex needs. Before Mr. Pratten and his colleagues sold Heath Lambert, an MBO, to Gallagher in 2010, he was Head of Client Development and Origination, and Head of Professional Negligence, D&O, Credit, Surety, Major Risks, Captives and M&A, forming the latter in 1996. He completed his MBA in 1998 and gained his Associateship of the Chartered Insurance Institute (ACII) in 1989.

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Simon Rootsey is European Counsel in Corporate and Private Equity, based in London, for international law firm Skadden. He has significant experience advising on all aspects of private cross-border M&A, private equity transactions, joint ventures and public takeovers. Prior to joining Skadden in early 2008, Simon worked in the corporate group of a leading Australasian law firm where he also focused on M&A. He also has been recognized in an international legal directory by peers who nominated him as a “rising star.” Mr. Rootsey received The M&A Advisor’s 2015 “European Emerging Leaders Award,” which recognizes up-and-coming lawyers under 40. His representative transactions include advising Nikkei Inc. on its \$1.3 billion acquisition of the Financial Times Group from Pearson plc; Russell Investments, a global investment services firm, in its US\$2.7 billion sale by Northwestern Mutual to the London Stock Exchange Group, and Formation Capital, a U.S.-based private investment management firm, in its US\$763 million acquisition of the NHP/HC-One Group. He has a Bachelor of Laws (Honours) and a Bachelor of Commerce (Finance (Corporate)) from the University of Western Australia.

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