



National Association of Corporate Directors
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Mergers & Acquisitions in 2011:
Out of the Ashes – Emerging Issues and Areas
of Concern for Directors as Activity Rebounds

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Summary Observations

M&A markets rebounded in 2010

- Across the board rebound of strategic and private equity deal activity from 2009 lows.
- With increased M&A activity comes increased opportunity and risk for companies and boards.

Transaction Considerations & Recent Developments

- Increased level of review and scrutiny of target boards in context of the transaction process and potential conflicts.
- With the increase in hostile activity, how are the application of certain deal protection devices viewed.
- Lessons learned or reinforced – well informed, conflict-free boards that preside over a defensible process are given deference.

What Boards can Expect in 2011

- Continued increase in M&A activity expected.
- What are likely questions and issues boards will confront.

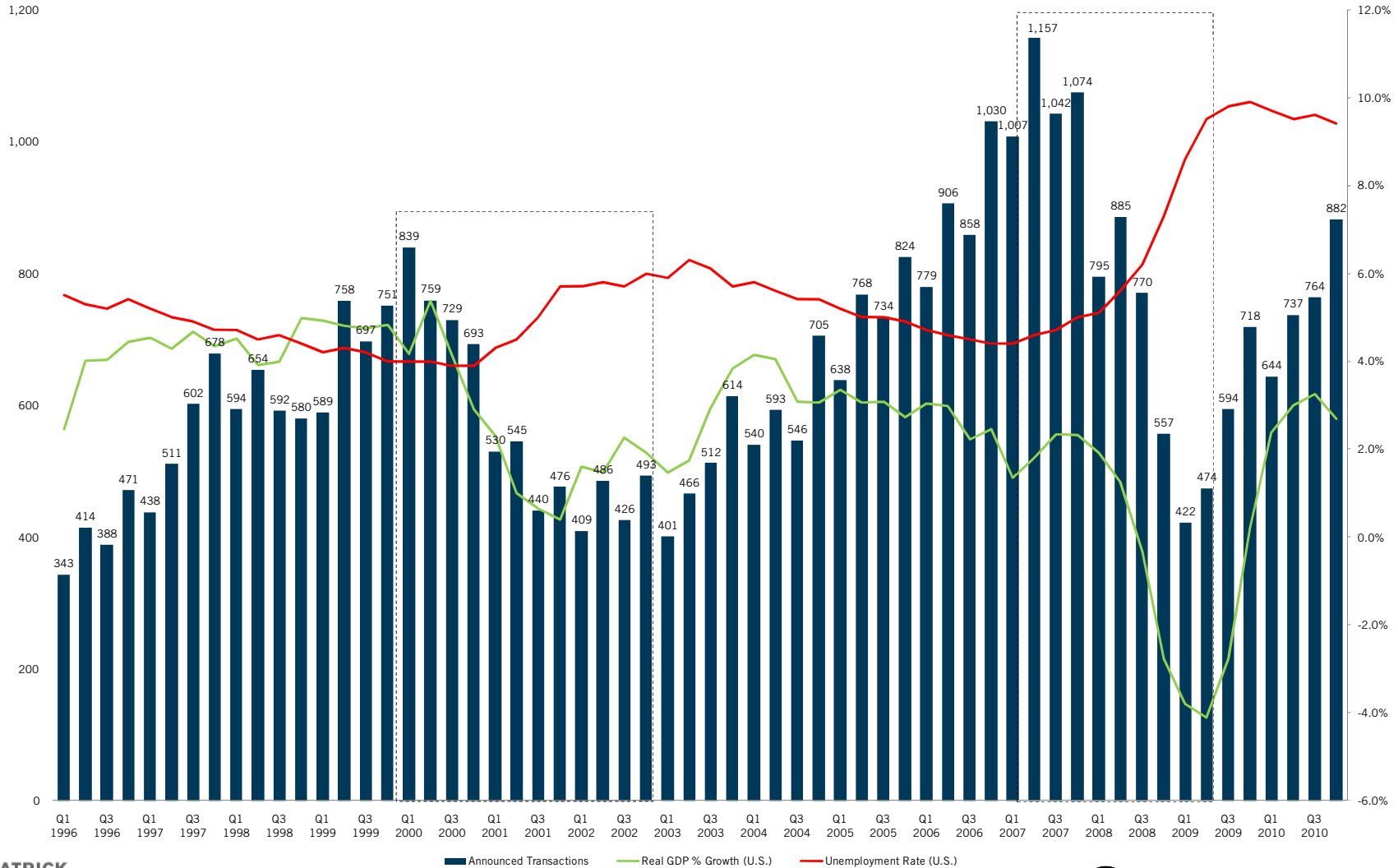


2010 M&A Market Overview

M&A Activity: Historical Context

M&A activity is cyclical with GDP and has typically recovered within two or three years of a downturn.

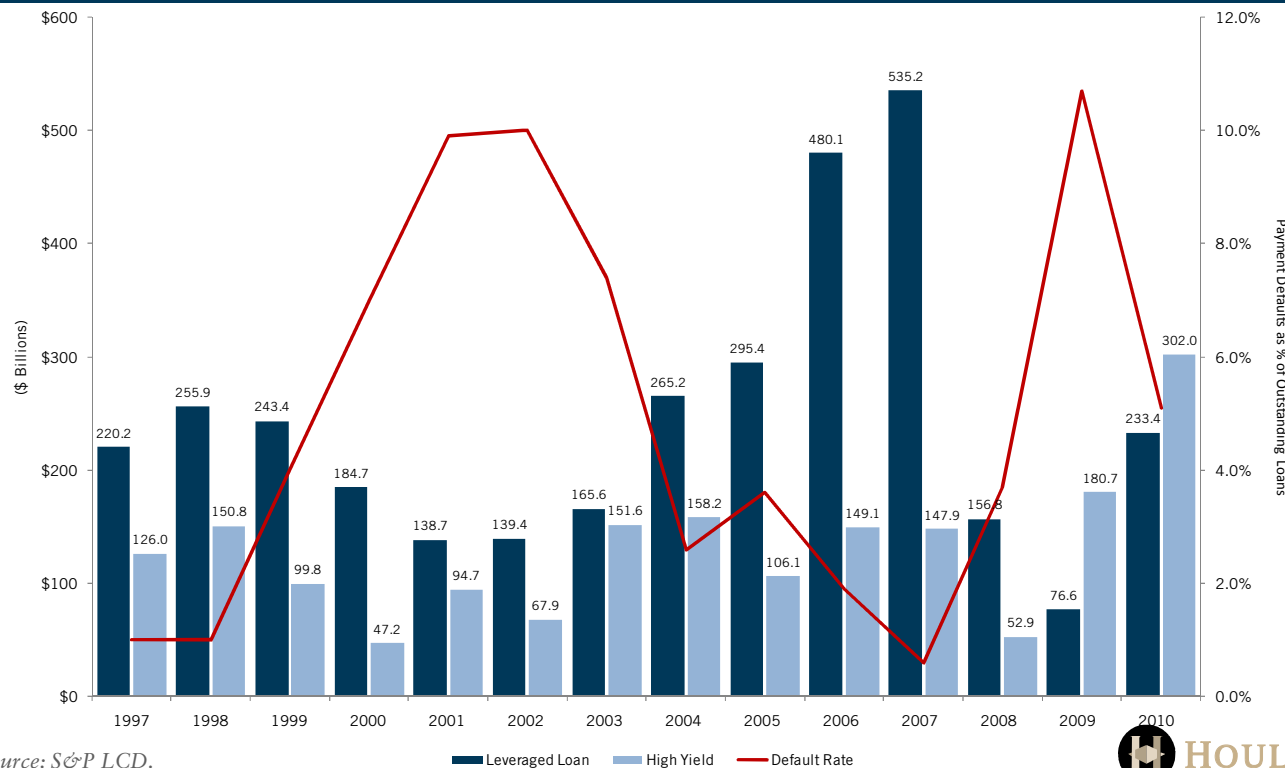
M&A Activity



High Yield and Highly Leveraged Loan Issuances

- Though still far below historically high 2007 levels, leveraged loan issuance volume in 2010 more than tripled 2009 levels
- High yield issuances set a record in 2010, following previous 2009 record – vast majority of activity were refinancings.
- Defaults hit a high in April 2009, stabilizing at 10.7% by 2009 year-end and declining to 5.1% as of December 2010.
 - While the default rate remains higher than S&P’s historical average of 4.6%, S&P predicts a decline to 2.4% by September 2011.
 - The year-end speculative grade default rate fell to 3.1% and Moody’s forecasts a further drop to 1.9% by the end of 2011.

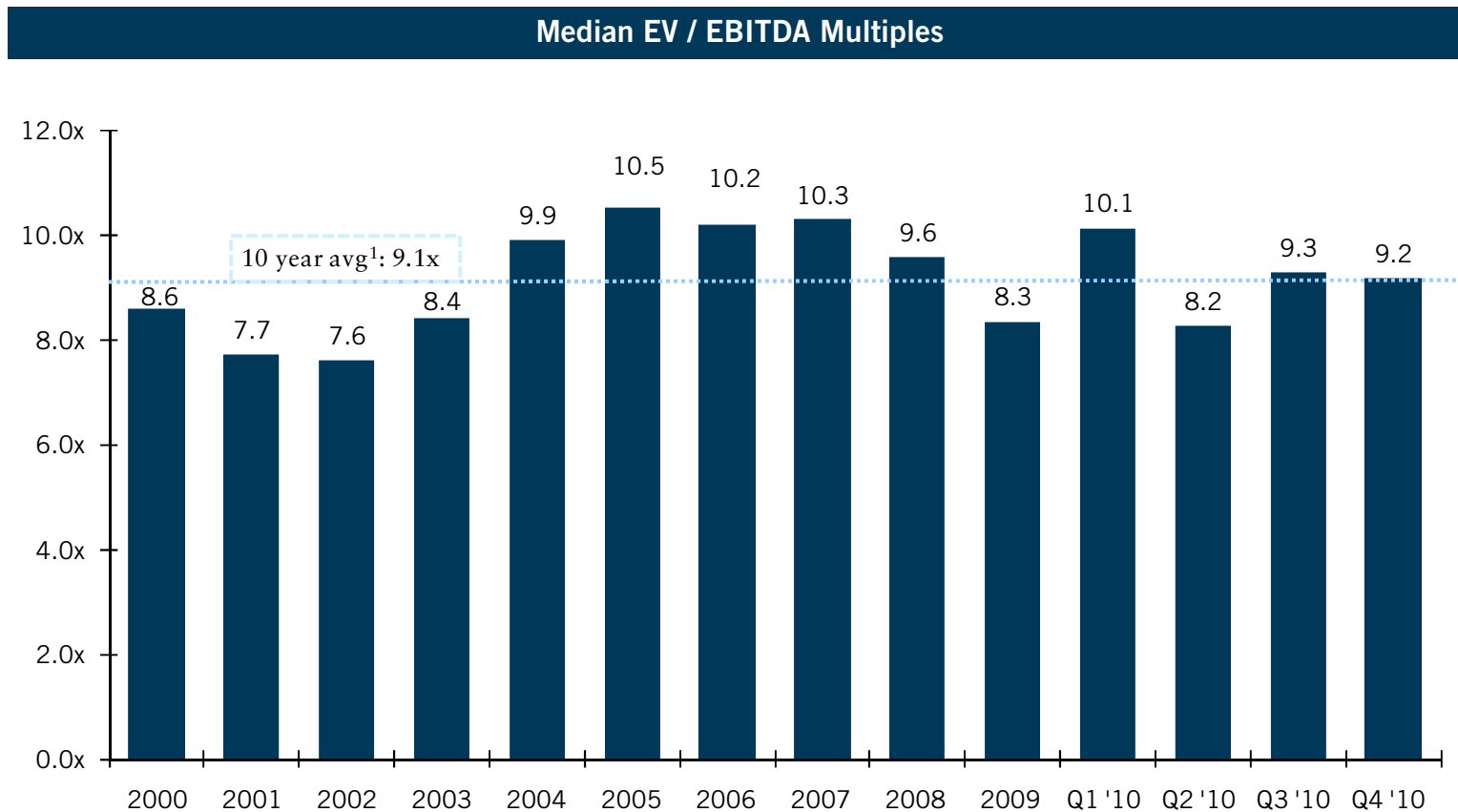
High Yield and Highly Leveraged Loan New Issuance Volume



Source: S&P LCD.

Transaction Multiples Have Rebounded

Average transaction valuations in 2010 were slightly above the 10-year historical average of 9.1x.



Source: Thomson Reuters, as of 12/31/10.

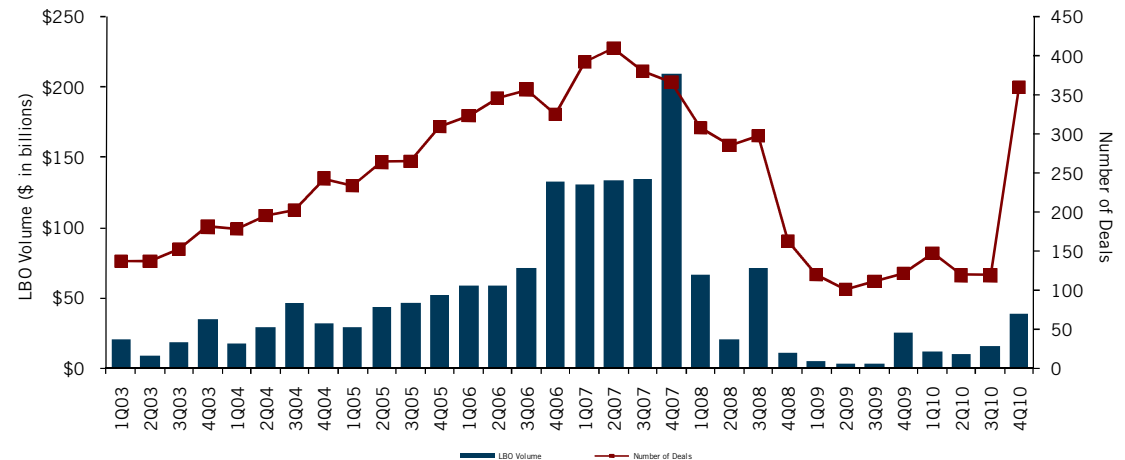
Note: Based on US deals and excludes multiples below 0.0x and above 25.0x.

¹ 10 year average based on 2000-2009

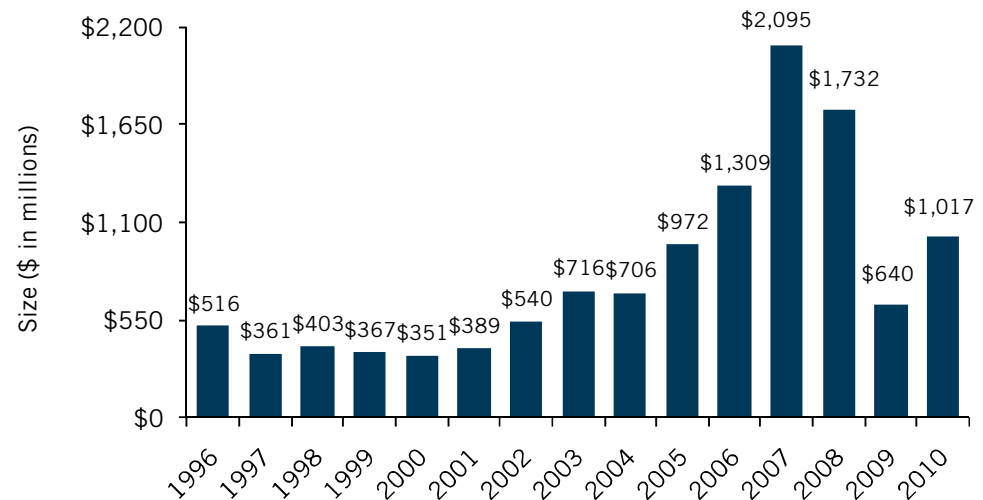
Recent LBO Activity

- Q4 2010 experienced a tax-driven year-end spike of activity with over \$60 billion in LBO investments in more than 350 transactions.
- Almost half of the overall 2010 LBO activity occurred in the 4th quarter.
- The average LBO deal size topped \$1 billion in 2010 as the appetite for large deals returned after the pullback in large deal activity in 2009.
- While the middle-market continues to represent the majority of PE transaction activity, LBO transactions of \$500 million or greater made up a majority of deal activity for the first time since 2007.

Total U.S. Leveraged Buyout Volume (2003 – 2010)



Average U.S. LBO Size (1996 – 2010)



Recap of Recent M&A Activity – Takeaways/Concerns for Boards

- Companies with substantial “excess cash”, borrowing capacity and renewed confidence are pursuing M&A more aggressively to drive growth, diversify and capture synergies, or realize value.
- Acquiror and target boards need to consider recent opposition by activists and other shareholders to certain M&A transactions relative to other available alternatives.
- Hostile transactions are more of a concern for companies given record cash reserves, low valuations in certain industries and fewer structural takeover defenses.
- Private equity firms have record levels of committed capital to invest and have aggressively pursued acquisitions by exploiting direct access to management teams and using tender offers as a speedier structure to get deals done.
- In several recent public-to-private sponsor-backed deals, the target boards have received criticism over the process (J. Crew, Del Monte).
- With increased deal activity, there has been a corresponding increase in litigation challenging poison pills (Airgas), clarifying the applicable “standard of review” for boards in “squeeze-out” transactions and other deals, and going after boards’ financial advisors for faulty advice or conflicts (Tribune, Del Monte).



Transaction Considerations & Recent Developments

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The Board Can Control Strategic Direction, Not Shareholders - Airgas

Strong Case to let the Shareholders Vote

- Offer in February 2010 at \$60 per share was a 50% premium.
 - Later increased to \$70 per share.
- No competing bidders emerged in over a year.
- Arbitrageurs had moved in, substantial number of shareholders wanted to sell.

Board Refused to Drop the Pill – Court Upheld

- Not a “Just Say No” defense.
- Board offered that \$78 per share would likely be adequate.
- Board was disinterested (it included three designees from the hostile bidder who ultimately sided with incumbent board members).
- Board relied on experts – very competent law firm and three separate financial advisors (the third firm was brought in late to check the first two).
- Rights plan upheld by Court based on precedent.

The Pure Process Employed by the Board Carried the Day

Not Only Directors Need to be Free from Conflict, but their Advisors Too

Del Monte Foods proposed takeover by KKR was enjoined for 20 days in February 2011

- because Del Monte’s advisors’ conflicts had caused a “flawed sale process”

Barclays had

- put KKR together with the highest bidder – contrary to a no-teaming clause;
- agreed to provide financing to the buyer before final price negotiations with bidders and did not disclose it to the Del Monte board; and
- ran the go-shop process after signing.

Atheros \$3.1 billion acquisition by Qualcomm enjoined March 4, 2011

- Advisor’s contingent fee not disclosed.
 - 98% of total fee.
 - Only 1 fairness opinion.
 - Process otherwise sound – disinterested, deliberative board.

Those that directors take advice from and that guide a sale process must be as free from conflict as the directors.

Recent Sponsor-Backed Take Privates – Processes Subject to Criticism

Health Grades

- Health Grades was taken private by Vestar for approximately \$294 million, or a 29% premium over the 30-day average closing stock price.
- Vestar provided an offer with no financing contingency, yet threatened to walk if there was a pre-signing shopping of the Company.
- Management interfaced and negotiated with the sponsor without the involvement of the independent directors.
- Questions arose about the process with respect to a single private equity bidder negotiator – did the board fulfill its duty to get the “best price” under Revlon when attempting to sell the Company?
- Post-signing go-shop.
- Court declined to enjoin the transaction on Revlon grounds absent a topping bid, coercive structure or disclosure violations, but seemed sympathetic to the view that the process was lacking.
- Roadmap for J. Crew deal?

J. Crew

- \$3 billion sale to two private equity firms which was initiated by the Company’s CEO.
- Shareholders criticized sale process and raised doubts that the Company set the “highest” price.
- Concerns centered around CEO informing the board of his discussions with the private equity firms seven weeks after talks began.
- Proposed remedies included an extension of the go-shop and reduction in the termination fee, but deal went forward.

While these processes faced criticism, use of post-signing go-shop among other factors was enough to carry the day.

Poison Pills: Still Effective to Halt a Takeover, but not Always

Delaware courts have consistently upheld poison pills if

- The process is pure – Board is independent, well-informed, acts in good faith.
- Is there a legitimate threat?
- Is the response reasonable?

Airgas – Process was strong

- Legitimate threat was that shareholders might tender for an inadequate price.

Selectica – First time a pill was intentionally triggered

- Pill set at a low trigger of 4.99%.
- Legitimate threat was that valuable NOLs would be threatened.

What's not legitimate?

- To entrench management.
- To protect corporate culture (*eBay vs. Craigslist*).

Deal Protection Devices: Termination Fees

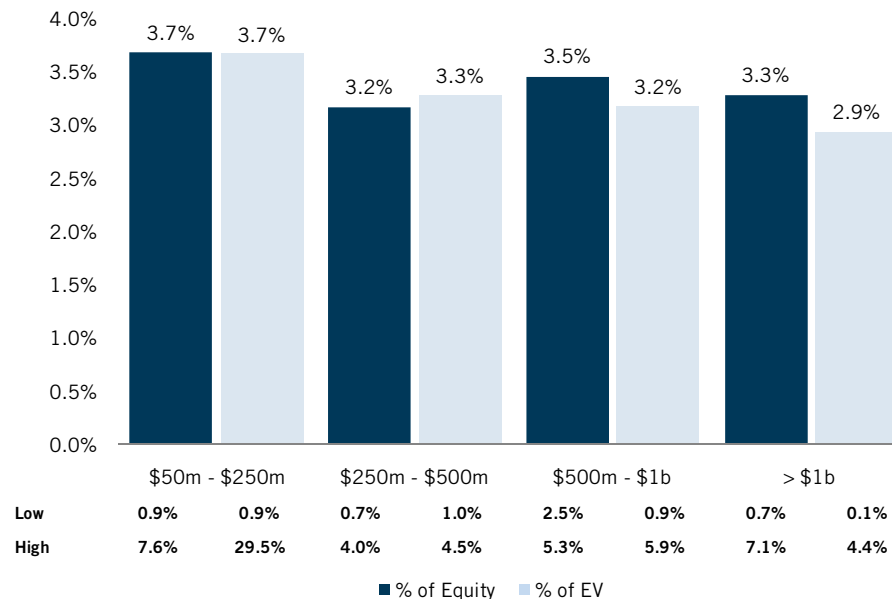
Courts provided some clarity in 2010 regarding how to measure termination fees.

General wisdom has been that termination fees of 2-4% of the transaction should be enforceable.

- A bit higher if deal has been shopped before signing (Toys R Us – 3.25% upheld).
- Higher for smaller deals.

Percentage based on equity value or enterprise value?

- **Dollar Thrifty** (Sept. 2010) said to look to entire value of the merger
 - 3.5% was upheld – measured against “entire value of the merger” flowing to shareholders.
 - Even with no pre-signing market check
- **Cogent** – Where buyer assumes significant debt, such as an LBO, use enterprise value



Source: Houlihan Lokey Termination Fee Study, 2009.

Focus on Financing Conditionality

Pre-2008, buyers were often willing to take risk of finding financing – not a problem.

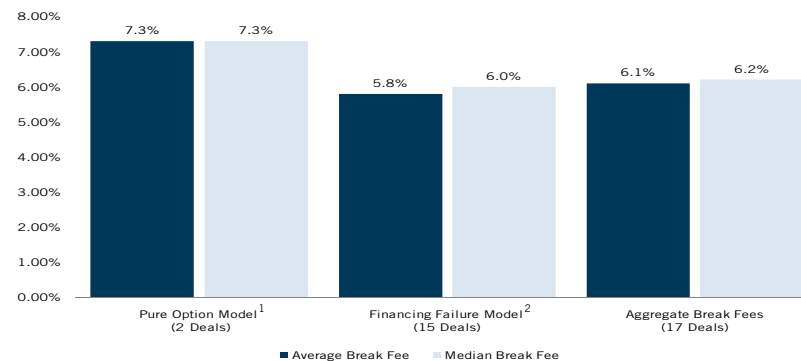
- As buyers failed to perform in 2008, these provisions got more attention.

Reverse Break Fees in early 2000's

- Often matched termination fees payable by buyers (2-3% of transaction value).
- Was sometimes used as a right to pay fee and walk from a deal – viewed as a “cheap call option” on the target.
- Not painful enough.

Today the focus is on:

- Rights to specific performance to enforce covenants to seek financing.
 - Much more detail in agreements as to what a buyer must do to secure financing.
- A more meaningful break fee if financing is not available (5-8% or higher).
 - With right to enforce specific performance so buyer can't voluntarily walk.
- 100% financing committed at signing.
 - Sponsor guarantees.
 - Bridge loan commitments – critical for conditions under which lenders can walk to match precisely with those under which buyer can walk.



1. For reverse break fee model deals with two-tier fee, only included pure option fee.

2. For financing failure model deals with two-tier fee, only included fee payable upon financing failure.

Source: Sample group of leveraged buyouts of U.S. companies since May 1, 2010 with an equity deal value greater than \$250 million, other than deals which are 100% equity funded, as of February 1, 2011. Thomson Reuters – Federal Securities Institute, February 2011.



Boards of Directors: What to Expect in 2011

Outlook for 2011

Expected M&A Themes and Trends

- Drivers for M&A activity in 2011.
 - Economic/strategic;
 - Capital markets/liquidity; and
 - Structural.
- Increased unsolicited/hostile activity.
 - Value of structural defenses.
 - “Deal Jumping”
- Increasing financial sponsor activity.
 - Take private activity;
 - Portfolio exits; and
 - Partial exits (IPO, dividend recap).
- Increasing corporate restructuring activity.
 - Spin-offs/split-ups as a means to enhance value.
- Shareholder activism.
 - Increased success rate.

Potential Questions Boards May Confront

- Do we understand our Company’s vulnerabilities?
- Do we know our shareholders and do they understand our strategy?
- The CEO wants to talk to a private equity sponsor about the Company. How should we proceed?
- Is our transactional process adequate and defensible?
- What standard of review are we subject to in this deal?
- What disclosure concerns do we have?
- Is our financial advisor conflicted?
- Do we need a fairness or second fairness opinion?
- What fraudulent conveyance concerns are there, and how do we address them?

Take Private Activity

- Take private activity increased in 2010 over 2009 as the leverage loan market returned and private equity became more active.
- With the continued improvement in the debt markets, the record level of undeployed private equity and the number of public companies that have a size and growth profile that make these companies less relevant to institutions, take private activity should see a further increase in 2011.
- Use of tender offers in two-step merger transactions have been on the rise.
- Board considerations/questions:
 - Entire fairness standard of review in 13e-3 transactions.
 - Independent directors and management.
 - Process/special committee.
 - Role of financial advisor.
 - Deal protection commentary.

Corporate Restructuring / Spin-offs

- The number of announced spin-off transactions have increased in the second half of 2010 and early 2011 with the recovery of the capital markets.
- Strategic consideration for the corporate spin-off alternative:
 - Deemed value maximizing in lieu of a divestiture or status quo option.
 - Business case typically centers around increased management focus and differing financing/capital structure requirements for the split entities.
 - Structured as a tax-free transaction.
 - These transactions include a cash dividend paid from “SpinCo” to “RemainCo” just prior to the separation.
- Board considerations:
 - Analysis of the viability of the separated entities.
 - Capital adequacy assessment.
 - Debt rating.
 - Analysis/assessment post-spin.

Shareholder Activism

Shareholder activism has maintained a robust pace.

- Trends in shareholder activism:
 - Increased success rate (over 50%).
 - Number of announced proxy fights remains robust.
 - Shown to generate favorable returns.
- Board considerations/questions:
 - Thoughts on shareholder communications.
 - Approaches to deal with activist shareholders.
 - Characteristics of shareholder activism campaigns:
 - Inefficient corporate structure.
 - Inefficient balance sheet.
 - Corporate Governance.
 - Event-driven action.



Houlihan Lokey Overview

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