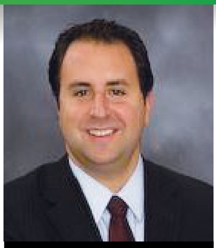
The Anatomy of an M&A Transaction: Knowing the Process Is Key to Success

Planet Fitness® franchisees are positioned to continue to witness a flood of deal-making activity in 2018, as the franchise industry – including the Planet Fitness system – has become a prime target for merger and acquisition (M&A) deals because franchising presents an array of investment opportunities for both strategic and financial investors.

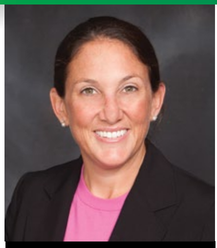
Whether you decide it is time to pull the trigger on your exit strategy or you have been approached by a potential buyer as an attractive acquisition target, the decision to sell is one of the most important in the lifecycle of your business. This article will provide a summary overview of the anatomy of an M&A transaction and some basic pre- and post-transaction planning tools to consider.

Deal Team

The first (and arguably, most critical) step in planning for an M&A transaction is assembling your deal team. Selling or



by Justin Klein



by Allison S. Becht

acquiring a business may be one of the largest financial and legal transactions in which you will be involved as a business owner. You will want to make sure that you have the right combination of professionals and advisors at your fingertips (e.g., accountants, attorneys, M&A consultants, investment bankers, financial planners, etc.). Franchised businesses face different legal and financial issues than most other business models. As such, you will want to ensure that your advisors not only have experience with M&A work generally, but that they have specialized experience handling M&A transactions in the franchise industry and, ideally, in the system in which you are or will be operating.

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Letter of Intent

Most M&A transactions commence with a letter of intent (LOI), which is typically prepared by the buyer and includes a formal offer to purchase the business. The LOI sets forth the basic economic terms and material conditions of the deal. While LOIs range in length, and vary in terms of content and complexity, the LOI should include, at a minimum, a description of what is being purchased (i.e., stock or assets) and the proposed purchase price. Other items of an LOI often include certain required closing conditions (e.g., third-party approvals, payment of related transaction fees, lien releases, etc.) and pre- and post-transaction covenants (e.g., "no-shop," confidentiality, non-competition, etc.); a more detailed description of some of these items follows below.

Structure of Transaction

There are several ways to structure a deal and accomplish the sale of a business – the most common ways being: (1) an asset sale (where substantially all of the assets of the business are sold to the third party); (2) a stock sale (where all of the stock – or in the case of a limited liability company, membership interests – of the operating company are sold to the third party); or (3) a merger (where the existing company and the acquiring company merge into one new company). From a liability perspective, typically buyers prefer asset sales and sellers prefer stock sales mainly because, in an asset sale, a buyer can cherry pick the assets it wants and leave all unrelated and unknown liabilities behind, whereas in a stock sale, generally speaking, all liabilities follow the ownership of the stock. There are also important state and federal tax considerations that factor into the deal structure; sellers and buyers should engage tax professionals at the LOI stage to advise on the tax benefits and/or consequences of settling on one transaction structure over another.

Purchase Price

Once the initial structure of the deal is proposed, the next key element in the LOI is the purchase price, including how and when the purchase price will be paid (e.g., deposits, equity, seller financing, earn-outs, holdbacks, etc.). There are a variety of approaches to valuing a business

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and determining the ultimate purchase price. Aside from trying to determine the net value of the assets, a common valuation mechanism – and a go-to method in the franchise industry (including in many recent Planet Fitness transactions) – is the EBITDA valuation method. In short, EBITDA is earnings before interest, taxes, depreciation and amortization. The EBITDA valuation method relies on a multiple of EBITDA to measure the company's operating performance and ultimately arrive at a company's value. It is advisable to engage an investment bank or other valuation professional to assist in the valuation process and affirm the final purchase price.

While most sellers would prefer an all-cash payment upon the closing of the transaction, buyers are often a bit more inventive in how they wish to pay the purchase price. A good-faith deposit payable by the buyer upon the execution of the LOI or the purchase agreement is an expected ask and range anywhere from 1-10 percent of the purchase price, depending on the particular market and the size of the transaction. Additionally, many buyers will require some percentage of the purchase price to be financed, be it from an institutional lender or the seller itself. In either type of financing arrangement, the buyer should be prepared to pay interest on the loan and give up a security interest in its newly acquired assets to the lender. The buyer may also want to propose that some of the purchase price be paid over time as an "earn-out" based on the company's post-closing performance. These payments are conditioned on the company meeting certain post-closing performance targets, and the seller typically has little control over the company meeting such targets after the business changes hands. Because of this, before agreeing to any such earn-out, a seller ought to be happy (enough) with their closing date cash payment as they may never receive the earn-out payments. One other commonly negotiated item relating to the purchase price is the indemnification "holdback." As the word suggests, this is a portion of the purchase price that is held back from the seller at closing and deposited instead in an escrow fund to secure the post-closing obligations of the sellers, namely as security to the buyer in the event that the buyer has any indemnification claims against seller after closing. As we will discuss below, a seller will want to limit the scope of indemnification obligations in the purchase agreement, but with respect to the holdback, it will want to clearly define the types of claims that the holdback is subject to, as well as ensure that the process for distributing holdback funds to the buyer is as restrictive as possible.

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Other Terms

Depending on the timeline of the sale and whether it is a "friendly" or "hostile" transaction, there are several other provisions the parties may deem advisable to include in the LOI. It is important to note that LOIs are most often "non-binding," meaning that the terms incorporated therein are mere expressions of intent and not legally enforceable (unless expressly stated otherwise in the LOI). One reason for this is that a buyer does not typically have its diligence review completed prior to signing an LOI, so it is essential for a buyer to have a bit of wiggle room in some of the deal terms, pending the findings of its review. This is not to say that it is not advisable to hash out some of the other key deal terms in the LOI phase when both parties are eager to lock the deal down and move forward.

Moreover, the more the parties negotiate during the LOI stage, the more efficient the lawyers can be when they move to drafting the definitive purchase agreement and other transaction documents. Some other provisions to consider including in the LOI include, without limitation: the buyer's right to conduct due diligence; scope of any restrictive covenants for the seller; parties' confidentiality obligations; "no-shop" provisions (prohibiting seller from engaging in sale discussions with other interested buyers); target closing date; payment of landlord lease assignment fees and franchisor transfer fees, as well as any of the other key purchase agreements terms discussed below.

Purchase and Sale Agreement

After the LOI has been executed, the legal team steps in to prepare the definitive purchase and sale agreement and all ancillary transaction documentation. Drafting and negotiating purchase and sale agreements in the franchise context requires a number of special considerations, so it is advisable to work with counsel who has worked in this unique M&A arena. Because of the franchisor's inherent control over the system, franchise agreements typically impose a number of restrictions on the transfer of such business interests regardless of how the transaction is structured.

For example, not only is the consent of the franchisor almost always required (along with certain conditions that have to be met before a franchisee can transfer its franchised business, including payment of a transfer fee), but the franchisor generally maintains a right of first refusal with respect to such transfers, meaning that they can step into the shoes of the third-party purchaser and purchase the franchisee's business interests for the same price and on the same terms and conditions contained in such third-party offer.

Aside from obtaining franchisor consent, more times than not, the seller's lease agreement requires the consent of the landlord to effect any such transfer or assignment of the lease agreement, which can take a lot of time and effort to track down and obtain. When negotiating new lease agreements (or when exercising a renewal option), it is good practice for franchisee counsel to incorporate a provision in the lease agreement that permits transfers to approved franchisees without the landlord's consent, as well as one that allows for the termination of any existing guarantees upon this type of assignment. A few simple, but insightful, changes to the lease agreement can save you a notable amount of time and money on your exit.

Finally, one of the most heavily negotiated issues in a purchase and sale agreement is the scope of the representations and warranties, and the correlation of such representations and warranties with the parties' indemnification obligations. An entire article could – and probably should – be written on such topics for franchisees and their lawyers alike. But, in a nutshell, the representations and warranties sections of the purchase and sale agreement contain certain statements of fact and other assurances made by one party to the other on which each party can rely when entering into the agreement. The seller's representations and warranties typically revolve around the information that the buyer needs to complete its due diligence and for which it is relying on to value the company, while the buyer's representations and warranties typically revolve around the form of consideration being used to complete the transaction and the buyer's ability to pay such consideration at closing. In an effort to allocate risk between the parties, purchase and sale agreements usually contain indemnification provisions. If it is discovered post-closing that a party did not do something that it agreed to do, or omitted or did not accurately represent something material, the aggrieved party can seek indemnification from the breaching party to cover any losses that such party has sustained. There are a number of ways to limit a party's (most importantly, a seller's) indemnification obligations in the purchase and sale agreement, including indemnity caps, baskets (tipping or deductible), reduced survival periods, etc. It is advisable to seek expert counsel in this area to ensure that your indemnification obligations are sufficiently limited (or, in the case of a buyer, sufficiently expanded) in the purchase and sale agreement.

Post-Closing Considerations

Most closings today happen electronically after a brief closing call, on which each party confirms that all of the closing conditions set forth in the purchase and sale agreement have been satisfied. There is little fanfare – balloons don't fall from the sky, parties typically do not ensue. But, providing that each party has been successfully counseled throughout the process by the various professionals identified above, the seller should walk away with a happy sum of cash and the buyer should walk away with the promise of a happy future.

After the closing excitement has settled, buyers and sellers alike should work with their deal teams to ensure that all loose ends are tied up and all post-closing matters handled. For a seller whose exit is not intended to trigger retirement, there are a number of tax-favorable opportunities in the franchise industry that can be considered (and should be in the early stages of the transaction). Additionally, all parties should consult with their attorneys and financial planners with respect to various post-closing estate planning matters.

The M&A process can be daunting but equally exciting and life-changing. Understanding the process will be helpful in easing certain tensions of the process. Carefully considering critical components of the deal through the planning stages and surrounding yourself with the proper team can be instrumental to a successful deal.

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