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JUDGMENT CALL

Bridging the bid and ask

Contingent value rights should be in the toolbox when the buyer and seller cannot agree on a price

BY FRANK AQUILA AND MELISSA SAWYER

Dealmaking in the past year has been, in a word, challenging. The spread between "bid" and "ask" is often wide, sometimes very wide. More than ever, deals are requiring creative solutions to bridge these valuation gaps. Contingent value rights, or CVRs, are derivative securities or contract rights requiring the buyer to pay the sellers additional consideration upon the occurrence of specified contingencies. CVRs are a bridge between a buyer and a seller who want to do the deal but who cannot otherwise agree on price. Although CVRs have been used in pharmaceutical and biotech deals for decades, CVRs are now gaining a foothold in deals outside the sector. Using CVRs will add complexity to the deal, but the benefits of CVRs' flexibility can offset the technical difficulties. As a consequence, CVRs should be on everyone's short list when the bid and ask do not meet.

Every CVR is unique because it represents a bundle of rights and obligations that are custom-tailored to the particular transaction. While each CVR will be unique, a few types of CVRs pop up frequently in M&A deals because they provide structural solutions to recurring negotiation roadblocks.

Deferred consideration. In a public company M&A deal, it can be difficult to structure an earnout or a post-closing purchase price adjustment. On the one hand, the buyer may want protection from changes in the target's balance sheet between the valuation date and the closing, or protection from the possibility that future performance will not meet expectations. On the other hand, the target's stockholders may want to get paid immediately in cash (or at least a transferable security) so that they can put the proceeds to use somewhere else. A properly structured CVR can bridge that gap.

An earnout CVR would pay out cash or securities to the target's legacy stockholders on the maturity date if a legacy business of the target is performing well post-closing. The CVRs would allow the target's stockholders to participate in the future upside from the target's operations without sharing those benefits pro rata with the buyer's legacy stockholders. At the same time, the CVRs would allow the buyer to defer payments, giving the buyer time to realize synergies and manage downside risks before having to part with cash, securities or other assets.

A purchase price adjustment CVR would pay out to the target's legacy stockholders if the target's financial metrics exceed a base amount. That is, the CVRs could function like a post-closing working capital or book value adjustment.

Hedging. A hedging CVR would pay out cash or securities to the target's legacy stockholders following a stock-for-stock merger if, on the maturity date, the buyer's stock is trading below an agreed level. These CVRs guarantee a minimum amount of consideration per target share after a prescribed period of time, even if the buyer's stock price drops after the deal is completed.

CVRs triggered by events. An event-driven CVR would pay out upon the occurrence, or failure to occur, of particular contingencies. These contingencies could include the following: (1) settlement/final disposition of lawsuit; (2) final resolution of a regulatory investigation; (3) final resolution of a financial restatement; (4) execution of a long-term income-generating contract on agreed terms; (5) the divestiture of specified assets; or (6) escrow release from an indemnification or other escrow account.

Financing solutions. CVRs can be used to supplement debt financing. These CVRs would be issued to financing providers to allow the buyer to pay a higher cash price to the target's stockholders while sharing the risk with financing providers, who may have a different risk/return threshold than the target's stockholder base (especially after performing due diligence).

There are two reasons CVRs may be more relevant than ever right now.

First, the markets have been so volatile the past 12 months that the target's and buyer's stock prices may not be moving in a direct relationship to each other, even if you exclude the impact of operational performance. In stock-for-stock deals with fixed-exchange ratios, that volatility can make it very difficult for a target to accept a buyer's stock as the deal currency. CVRs offer two ways to resolve that issue: (1) they can act as a hedge against the buyer's stock price, effectively imposing a collar on the bottom end of the fixed-exchange ratio, but with more bells and whistles than a traditional price-based collar; and (2) they can provide additional compensation to the target's stockholders if, post-closing, the target's legacy businesses outperform the buyer's legacy businesses.

Second, for buyers who do not have access to reasonably priced credit, or who are subject to regulatory or practical constraints on using cash consideration in a deal, CVRs can provide an invaluable source of transaction financing without diluting their existing stockholders or having to access the debt markets.

There is much untapped potential for the use of CVRs in M&A deals outside of the sectors—biotech and pharma—where they have been traditionally used.

CVRs can be complex and do present numerous thorny issues that the parties and their advisers will need to address at the outset of the deal, but with a little creativity, CVRs can be invaluable tools in bridging the value gap in M&A deals. ■

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