Introduction

Price is what you pay
Value is what you get
Warren Buffet[1]

Cutting the terms of a private cross border M&A deal is a business and legal exercise in designing, negotiating and memorializing a *risk allocation* that protects the *return requirements of Buyer and Seller*.

To begin to unpack this organizing principle of M&A deals, let's begin from the simpler proposition that Buyer and Seller engage in a purchase and sale of a target business for the purpose of earning a return that is above their respective cost of capital. In other words, for the M&A deal to happen:

(*a*) Buyer must have reached the conclusion that entering into a deal to buy Target offers an opportunity to deploy funds that will earn a return above the cost Buyer has to pay to its capital providers (whether LPs and creditors in the case of private equity investors or shareholders and creditors in the case of strategic investors); this, in turn, will only happen if Buyer expects that, during the investment period, Target will generate cash flows and an exit valuation that yields a return over and above the purchase price of Target and the cost of such capital;

(*b*) unless Seller is motivated to sell by other considerations[2], Seller will generally wish to enter into a deal to sell Target only if monetizing all or part of his or her interest in target will allow him or her to use the proceeds in a manner that will result in a return higher than the return it would have received by holding on to Target; this, in turn, will only happen if Seller expects that the purchase price of Target adequately compensates the Seller for the cash flows that it is foregoing by selling Target.

Note that the focus of Buyer and Seller is the *valuation* of Target which is not the same as the *purchase price* to be paid for Target. The purchase price is simply the result of a negotiated bargain between the parties against the backdrop of their respective valuations of Target. Moreover, as discussed in later chapters, the purchase price also reflects the financial position (cash and debt) of Target at

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[1] [Add reference]

[2] [See discussion in Chapter [X] re Purchase Price.]

closing. Ultimately, Buyer will strive for a purchase price that is equal or below his or her valuation of Target and Seller will aim for a purchase price that is equal or above his or her valuation of Target. In sum, at the end of the day, *the valuation of Target by Buyer and Seller is the economic cornerstone of the M&A deal*. Thus, cutting the terms of the cross-border M&A deal requires having a basic understanding of the key assumptions behind the valuation of Target.

In order to be effective advocate for their business clients, lawyers do not need to be able to create valuation models, but they do need to understand the drivers of the models used by their client. Buyer and Seller have a narrative about Target that shapes the deal. Lawyers need to be clear about the assumptions made by clients in developing their valuation of Target in order to design, negotiate and memorialize a deal that protects the economics sought by their clients.

Our Educational Objectives

The unifying idea of this course is that the economic objectives of the parties, the allocation of business and legal risks and the management of the uncertainties inherent in cross-border investments are the drivers of the negotiation and the terms of the cross-border deal. Thus**,** we will begin by exploring this principle through materials focused on providing a basic understanding of: (*i)* the principal valuation methodologies used in deal-making, (*ii*) the business and legal due diligence process, and (*iii*) the pricing and pricing adjustment mechanisms in deal documents. With that as background, we will then move on to briefly consider deal structuring which will then lead us to the contractual architecture of the acquisition agreement and its dynamic relationship with the economics of the deal. This central part of the course will focus on the relationship between the economics of the deal and each category of provisions in the acquisition agreement, namely representations and warranties, covenants, closing conditions and indemnities. The discussion of the architecture of the acquisition agreement will conclude the first part of the course equally applicable to domestic as well as cross-border private M&A deals.

In the second part of the course, we will focus on the additional layers of complexity raised by multi-jurisdictional deals. We will start by considering how to handle the interaction between the governing law of the deal and the laws applicable to Target in the foreign jurisdiction. We will then consider enforcement issues , with a particular attention to various arbitration mechanisms and their impact on the design of the deal. Political risk and currency risk will be studied to assess whether and how foreign investors can mitigate them and, in some instances, even leverage them to generate higher returns. Other topics that will occupy us in the second part of this course include: a discussion of governance issues in the cross-border context, the impact of corruption issues in M&A transactions and the different roles of private equity and strategic investors in the cross border deal.

Some Financial Concepts

Prior to launching into due diligence and the valuation process, we need to gain at least some basic understanding of a few foundational economic, accounting, and financial concepts that are relevant to the M&A process: return, risk, time value of money, leverage and cash flow. We will introduce these concepts in the balance of this introductory note, but first an important *caveat*: please be forewarned that this brief and rudimentary primer aims only at providing tools for a lawyer to operate in an M&A transaction. For those interested in a rigorous and academic treatment of these concepts, please refer to the works referenced in footnotes that provide a scientific and scholastic treatment of these concepts beyond the scope of this note.

Return on Investment[3] is a metric that measures the profitability of an investment by taking into account the amount originally invested, any additional investment that may be required, the distributions received from Target and the exit value of the investment. In M&A transactions, Buyers often refer to their required return requirements for a particular investment. This is a reference to the return that has to be realized over and above the cost of the capital to be invested. The required return requirement is a function of the perceived investment risk of Target. Investors require higher returns on investments for riskier investments.

Risk[4] is most usefully thought of as the probability of an outcome that is different from the expected outcome. In the case of an M&A transaction, the most significant risk faced by a Buyer is that the actual return on the investment in Target will be lower than the return on investment expected when the acquisition was consummated. This risk is a function of the several business and legal risks that Target faces, including: risks deriving from competition, changes

[3] [Need to identify a few good academic articles explaining return on investment and the correlation between risk and return in investments.]

[4] [Need to identify a few good academic articles explaining risk in investments.]

in consumer preference, macro-economic developments, leverage, liabilities and other factors that might lower profits or increase costs.

Time Value of Money[5] implies that a dollar today is worth more than a dollar in the future because a dollar today can be invested and will grow over time. This is a key concept in valuation because the value of Target is to be determined taking into account the fact that cash flows in the immediate future are more valuable than cash flows in the distant future.

Leverage[6] refers to the fact that a return on the equity invested by Buyer in Target can be boosted if part of the purchase price is financed with debt. If the overall return on the investment in Target is higher than the interest payable on the debt (the portion of the return payable to the creditors), Buyer will be able to earn an increased return on his equity. The trade off is that by using leverage the Buyer faces a higher risk of bankruptcy if the investment does not work out as expected because the debt and the interest on it must be paid in accordance with the financing documents.

Cash Flow or EBITDA is the metric most commonly used in valuation models to measure the results of Target. Cash flows rather than profits are used to value Target because profits do not factor in the funds that need to be periodically reinvested in Target to maintain its asset base and business operations. Two businesses might generate the same level of profits year after year, but they throw off very different cash flows if one is asset-intensive whereas the other is asset-light.

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[5] [Need to identify a few good academic articles explaining time value of money.]

[6] [Need to identify a few good academic articles explaining the effects of leverage.]