

The Auction Process: Advantages and Disadvantages and the Key Steps

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Mergers and acquisitions represent a key growth strategy for many corporations. The M&A landscape is becoming increasingly competitive and the balance of power is shifting further in favour of buyers. For attractive businesses, however, sellers may wish to make divestments through an auction process which is designed to elicit competitive bidding among interested parties to facilitate the sale of a business or stake in a company at the highest price and on the best possible terms. This article seeks to explore the auction process and discusses:

- (1) the differences between a competitive auction and bilateral negotiations;
- (2) the advantages and disadvantages of a competitive auction; and
- (3) an overview of the key steps in an auction process.

Auction Process vs. Bilateral Negotiations

Business owners deciding to sell a company or business may choose to sell by way of bilateral negotiations or a competitive auction process. Unlike bilateral negotiations where a seller

and a buyer negotiate directly, in a competitive auction, the seller seeks competing bids from potential buyers for the target. Further, in an auction process, the seller will carry out a substantial amount of work before the process is underway and, as a result, generally require the engagement of advisers in the early stages to prepare for auction launch. In bilateral negotiations, the buyer often provides a “shopping list” of requirements for the due diligence investigation. In an auction, however, the seller controls the disclosure process by limiting the scope of information made available and ensuring that disclosure is made in a

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controlled manner, usually through the use of a data-room. Finally, an auction process often involves an expedited transaction schedule.

There are circumstances, however, where an auction process is not suitable. If the business is structurally complicated or if the market sector is limited and there are only a handful of viable bidders, the additional complexity of, and costs associated with, an auction process may not be worthwhile. Where significant external factors may affect a transaction, such as regulatory or competition issues or third party consent requirements, the potentially protracted timescale in resolving those matters may undermine a key benefit for the seller – i.e. speed. Further, where such external factors exist, the standardised documentation prepared in connection with an auction process may be impractical or impossible for certain bidders.

Auction Process: Advantages and Disadvantages

Advantages for the Seller

Auction sales may provide a number of advantages for the seller. In an auction process, the seller (together with its investment bank or adviser) may comprehensively survey the market to uncover more potential buyers. Further, the seller controls the auction process and can seek to create a competitive environment in order to maximise its bargaining power. By encouraging the potential buyers to bid against one another, simultaneously negotiating with more than one bidder and keeping confidential the number and identity of bidders, the seller may achieve a higher price than otherwise possible under bilateral negotiations. The seller also produces the first draft of the sale and purchase agreement, placing itself in a strong position to obtain more favourable terms and

conditions from the start. The seller may also improve its leverage by imposing an expedited timetable, limiting the scope of disclosure of information and setting the timing of bidders' due diligence investigation.

Disadvantages for the Seller

Nevertheless, there are disadvantages the seller must consider. The cost of running an auction sale is inevitably higher compared to bilateral negotiations as a result of higher fees payable to advisers. The seller will generally engage financial, legal and other advisers in the initial stages to assist in establishing a strategy for the auction process. Legal fees will inevitably be higher as the seller's lawyers are responsible for the preparation of the initial suite of documentation. Having to concurrently negotiate with more than one bidder also adds to the overall costs of the advisers for the seller.

Given the multiple parties in an auction process, the wider dissemination of confidential information also poses a risk to the seller, especially where a bidder is a competitor – and, particularly, where such competitor's participation in the auction is primarily for information gathering.

The likelihood of the seller negotiating with more than one bidder may also impose additional strains on the seller and the target's management. Further, the knowledge of the sale alone may lead to negative consequences such as loss of, or a deterioration of morale among, employees, or even loss of business or customers. For these reasons, the seller often seeks to disclose information on a need to know basis (including the fact of the sale) – particularly as any public knowledge of the seller's failure to sell the target would negatively impact the reputation of the target and the seller's ability to attract a good price in a subsequent sale.

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Buyer Perspective

Of course, any benefits sought by the seller from an auction process will be to the detriment of the buyer. Given the potential competition posed by other bidders, a potential buyer may end up paying more for the target than it would otherwise pay. Additionally, in order to appear attractive to the seller, a bidder may be willing to accept weaker contractual protections and avoid making substantive changes that are not absolutely necessary to the sale and purchase agreement. Further, if there are other viable bidders, a potential buyer risks a higher chance of not being selected as preferred bidder, resulting in wasted costs and management time. Finally, due to the seller's control over disclosure of information, a bidder may end up submitting a binding offer without the benefit of the full picture of the target and its business. For these reasons, it is in the interest of a bidder to obtain a period of exclusivity as soon as possible in order to redress the balance and to proceed to the extent possible as if the transaction was a bilateral negotiation.

“ In addition to lawyers and accountants, sellers almost always instruct a financial adviser in the early stages to prepare the information memorandum and coordinate the process by acting as the point of contact between the seller and the potential buyers. The involvement of an investment bank will lend credibility to the process and enable the seller to reach a wider range of potential buyers through the bank’s contacts.

The Auction Process: Key Steps

The timing and steps in any given auction process will differ from transaction to transaction. However, auction processes tend to involve: the distribution of an information memorandum to bidders; a first round of indicative bids by the bidders; due diligence and review of a draft sale and purchase agreement by bidders; a further round of bidding by a limited number of bidders together with their comments on the draft sale and purchase agreement; and negotiations between the seller and one or more preferred bidders.

Prior to an auction process, however, the seller has a substantial amount of preparation. In addition to lawyers and accountants, sellers almost always instruct a financial adviser in the early stages to prepare the information memorandum and coordinate the process by acting as the point of contact between the seller and the potential buyers. The involvement of an investment bank will lend credibility to the process and enable the seller to reach a wider range of potential buyers through the bank’s contacts. Of the likely bidders, the seller assesses whether there may be any particular constraints to successfully concluding a transaction that may arise. To that end, the seller will likely consider the activities of a bidder and any combined market share for relevant products or services that may raise competition or anti-trust concerns; any external approvals required by a bidder which may slow down the transaction; any required employee consultations; any concerns by a bidder of post-completion operations; and the transaction structure.

Information Memorandum and Indicative Bids

After potential buyers enter into a confidentiality agreement with the seller, the auction process commences upon the distribution of the process letter and the information

memorandum to the bidders. The process letter will set out the details of the auction process, such as timings, procedures and next steps, and will invite bidders to submit a non-binding indicative bid. Additionally, it often identifies any regulatory, merger clearance or other issues that may reduce the likelihood of concluding a transaction in a timely manner. In order to provide the seller with the greatest level of flexibility, the process letter generally avoids setting out the criteria for evaluating bids and includes a statement that the highest price will not necessarily succeed. The seller will often also reserve their right to amend or discontinue the auction at any time.

The information memorandum is a document that aims to contain reasonably sufficient information about the target to elicit meaningful bids from potential buyers, such as: a description of target’s business, industry and history; the principle assets; historical financial information and future projections; information about management and employees; and depending on sensitivity of the transaction, information about key customers and contracts.

Following submission of indicative bids, the seller and its advisers will assess the offers and will decide which bidders to invite to participate in the next round of bidding where the seller will make available further information and the remaining bidders will conduct their due diligence investigation.

Due Diligence, Site Visits and Management Presentation

In preparation for the next stage of the auction process, the seller generally carries out in advance due diligence on the target to identify, and resolve if possible, any issues in order to avoid any undue delay to the process. Unlike in bilateral negotiations, where a buyer often requests the information that it needs to assess the target and its business, in an auction process the seller controls the disclosure process,

balancing between disclosing as little as possible and disclosing enough to ensure that a bidder may adequately make its assessment. To speed up the process, and to avoid any delays, the seller often produces a seller's due diligence report, together with other independent reports such as an accountant report, which contains all the material information that a bidder would reasonably require. To aid in the disclosure of information in a controlled, efficient and timely manner, the seller generally uses an online dataroom – although, some sellers choose to use a physical dataroom where information is, or the circumstances of the auction process are, particularly sensitive.

Again, in order to control the disclosure of information, the seller generally prepares and scripts in advance site visits and management presentations and bidders are also expected to provide in advance any questions that they may have. The seller's advisers are generally present to ensure that the seller handles the disclosure of information as planned and bidders do not raise any questions beyond the pre-set plan or make any unauthorised approaches to employees during any site visits or management presentations.

The seller often makes available at this stage a draft sale and purchase agreement and encourages bidders to review and comment on the agreement. The initial draft is almost always seller-friendly and will reflect the seller's positions on key transaction terms, such as the form of consideration, conditions for closing, the scope of representations and warranties and limitations on liability.

Final Offer and Negotiations

Following the due diligence exercise and review of the sale and purchase agreement, the remaining bidders will be invited to submit their final offers together with their comments on the agreement. The price is often the determining factor; however, certainty

of available funds and a cooperative bidder may be equally important, demonstrating a bidder's commitment to closing the transaction. As such, a bidder must be strategic and consider, outside of price, how it approaches the sale and purchase agreement. Typically, bidders submit a mark-up of the draft sale and purchase agreement or a key issues list. Submitting a comprehensive mark-up of the draft sale and purchase agreement may demonstrate commitment to the process. However, bidders should limit comments to substantive matters (such as risk allocation provisions) and avoid any stylistic or unnecessary changes. A heavy mark-up or inclusion of open-ended conditions may give the impression that a bidder may be difficult in negotiations. Alternatively, bidders may opt, or may be requested, to submit a key issues list. This may be useful to focus the seller and the relevant bidder on issues that raise the most concern for each of the parties. Generally, if a bidder's price is in the right range, the seller is unlikely to dismiss the offer as a result of an over-zealous mark-up without further discussions.

Upon the seller's assessment of any final bids, it will select a preferred bidder (or preferred bidders). During the final negotiations, the seller will try to maintain the momentum to avoid any delays and to resist any efforts by the preferred bidder to introduce new points or to renegotiate accepted points. On the other hand, a preferred bidder will see this as an opportunity to conduct negotiations as much as possible as if the process were a bilateral negotiation. The successful strategy will largely depend on the parties' respective bargaining power.

Final words

Numerous companies are aggressively using M&A to enter new markets and/or new sectors. Other companies are making acquisitions to increase their market share.

Some companies are selling down their interests in a particular market or sector in order to raise capital or to focus on their strengths in other markets or sectors. This presents opportunities for companies to enter or expand in a particular market or sector.

No matter your company's goals in acquiring or disposing of an asset, the M&A auction process is one which has advantages and disadvantages for both sellers and buyers. Financial advisers, lawyers and accountants should be engaged early in the auction process, no matter if you are the seller or a bidder, in order to assist your company to succeed in an auction process and to proactively help your company to manage the transactions complexities.

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