Staple Financing as a Mechanism for Adding Value to Asset Divestitures – The Case of BP

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Executive Summary

The term staple financing (SF) refers to a situation in an M&A transaction in which the financing arm of the sell-advisory bank "staples" a financing offer to the asset or target company being sold. The buyer (s) can choose to accept or not the SF offer. In theory SF is attractive to sellers because it mitigates the risk that the buyer is unable to raise financing to acquire the asset, decreases the time to closing the deal, and sends a comfort signal to buyers, which could potentially result in a higher sale price. In practice, some sellers (e.g. BP) see that SF adds marginal value, and are concerned with the conflicts of interest between the sell-advisory and buy-financing role of banks.

The aim of this research project was to provide an independent and pragmatic view of the extent to which SF can add value to sellers, and particularly to the case of BP. Because there is no literature or previous research on SF, this research project focused on gathering, compiling and analysing primary information from investment banks, sellers and financial buyers. This information was used as the basis for understanding the mechanics of a typical SF offer; the motivations of sellers, advisors and buyers to use or not SF; and the impact of SF in two recent deals – Viterra Energy Services (Germany) and TransDigm Inc (USA). Based on this understanding the author suggests a method for quantifying the value added by SF in specific deals, and a checklist for analysing if SF should be further considered by sellers for a specific deal. These tools were developed with the specific case of BP in mind.

The mechanics of SF combine elements of an advisory and acquisition finance mandate. It is offered by sell advisory banks in deals in which they consider that it improves the terms of the sale, and in which lending is attractive to their financing arm. Banks believe that SF can improve the terms of the sale if the potential buyers are financial buyers that would make a highly levered acquisition, and if the bank is able to make an aggressive financing offer. If the seller agrees to use SF, the advisory and financing teams will work together during the preparatory stage of the sale and the financing offer (FO). These teams will conduct their own due diligence and will share information that will allow the financing team to develop a package tailored to the terms of the sale and the credit profile of the asset.

After completing the information memorandum and FO, the two teams will be Chinese walled as they are effectively working for different clients. The financing team will market the FO with all bidders and will divide itself into teams (trees) to work independently with each of the bidders that decide to use the FO. These trees will work with each bidder to tailor the financing offer to their own needs. To ensure independence between the advisory and financing teams, and between the trees of financing teams, banks require a significant amount of self-discipline. This self-discipline is at the heart of the conflict on interest concerns of sellers. Once the deal closes, the successful bidder will pay the financing fees to the SF bank.

The table below summarizes the key motivations of sellers, advisors and buyers to use or not SF.

Sellers	
Motivations to Use SF	**Motivations Not to Use SF**
Secures financing therefore reducing financing execution risk, i.e. the risk of having to adjust sale terms during post-auction negotiations with buyer's lenders. This risk is compounded with financial buyers who typically make highly levered acquisitions	Conflict of interest between the advisory and financing role: - Advisory team sharing with the financial team information that the seller considers confidential and critical to the deal, e.g. extent of contingent liabilities, "real" EBITDA, etc - Advisor will tend to favour bidders who accept the financing offer
Pre-sets price expectations in the market and supports good first round offers	May create conservative expectations of value with buyers and remove prospects of a high "outlier" bid
Advisors / Banks	
Motivations to Use SF	**Motivations Not to Use SF**
In addition to improving sale terms, it significantly increases expected fees. For a £500M deal the typical advisory fees are about £3 to £4M, and the financing fees are between £10 to £12M	Deals in which buy side clients have high concerns about conflicts of interest and bank is unwilling to upset the relationship with the client
Synergies between advisory and financing teams can result in cost savings	Offering acquisition finance is unattractive: majority of buyers are trade-buyers; deal size <£250M (in the case of large banks); asset has poor credit profile; or bank unlikely to have subsequent relationship and major follow-on business with sell-side
Buyers	
Motivations to Use SF	**Motivations Not to Use SF**
Financing terms are more aggressive than those offered by other lenders	Uncomfortable with the SF bank working in parallel with the seller and other bidders
Other things being relatively equal, advisors may tend to prefer a bidder who is using their SF package	

The information gathered from this study indicates that:

- SF has been rarely used – less than 5 deals in Europe, although it has gained popularity in recent months,
- Only advisors/banks appear to be keen to use SF, i.e. it is supply driven – the benefits to banks are directly measurable and significant, however as sellers understand its effects on reducing execution they are becoming more interested,
- SF added the most value to sellers when it was used in a non-standard form, e.g. as bargaining tool.

Initially the majority of the instances in which SF was used were deals in which the bank offered it, and not in which the seller requested it. This implied that in general the view of sellers was that the costs (principally the opportunity cost of the time and resources to support financing due diligence) of SF outweigh its benefits. As sellers have gradually recognized the benefits of using SF to reduce execution risk, they have been more proactively requesting it.

However, the circumstances for its value-adding use by a seller are limited and difficult to isolate and measure. These circumstances are likely to make the situations rather specific, so the idea that a general purpose 'one-size-fits-all' tool like standard SF is not likely to be a solution.

Therefore, the conclusion is that the tactical use of the seller's bank in a flexible way to improve negotiations in the sale of assets is sensible, but that standard SF is unlikely to be a panacea solution.

Further to this conclusion, the author developed a checklist to screen the deals in which SF might add value. The logic behind this checklist is that SF is a relevant proposition for a specific deal if it responds to the motivations of all parties. Part of this checklist involves estimating the benefits to BP. Benefits can be estimated by measuring the value that SF could add in a specific deal. The author also developed a methodology for measuring this value. Following the development of these methodologies, the author recommends a follow-on research study that tests these methodologies with several BP case studies.

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Introduction and Background

This paper presents the main findings of a research project that reviewed the extent to which Staple Financing (SF) could add value to M&A transactions. The study extrapolates these findings to the case of BP's asset divestitures.

For strategic and economic reasons large oil companies sell millions of dollars worth of oil and gas assets per year; for example BP sold $5bn last year. [1] Trade buyers typically acquire these assets - i.e. medium to small size oil companies (e.g. Amerada Hess, Apache) for which these assets are attractive investments. Trade buyers typically buy 90±% of the assets, with the balance purchased by institutional investors through their fund managers, i.e. private equity funds (e.g. Carlyle, Blackstone, KKR, etc.).

Private equity funds are the buyer of last resort for oil companies. Trade buyers would normally pay higher prices because they see financial and strategic value in the acquisition. A strategic valuation would add to the offer price some portion of the perceived positive effects of synergies with the existing operations of the trade buyer; synergies rarely if ever available to private equity funds. Private equity funds, on the other hand, would value the asset from a financial-only point of view, and would expect to achieve higher financial returns than trade buyers (i.e. 20 or 30% after-tax), therefore leading to lower offer prices.[2] This explains why sellers prefer trade buyers and generally only solicit private equity interest when trade buyer demand is weak.

Trade and non-trade buyers also differ in the source of financing that they use to fund the acquisition. It is more efficient and less costly for trade buyers to use corporate sources, i.e. retained earnings, corporate debt, etc. to finance the acquisition. Non-trade buyers would commonly finance their acquisition through a combination of equity and debt. Debt, commonly around 60 to 70%, would be arranged on a project finance basis, i.e. tied to the asset that is being acquired. With a highly levered capital structured and little operational synergies, non-trade buyers commonly expect to add value through, among other elements, financial engineering. In this context, SF could add value by facilitating the allocation of capital in non-trade buyer acquisitions.

Typically the seller hires an investment bank's M&A division to serve as advisor during the sale process. The role of the advisor is to assist the seller in estimating a sale price, in preparing a data room and information memorandum, organising sales presentations, marketing, and supporting the sale process. Advisors are paid a success fee based on the sale price.

Assets are commonly sold through closed bid auctions with typically less than 10 firms participating in the final bidding - in theory the buyer that offers the highest price will get the asset. It is not uncommon for sellers to find themselves in situations – typically with non-trade buyers - in which closing the deal after auction has taken much longer than expected. Sellers perceive that the delay in closure post auction - as

[1] The terms assets and target are used indistinctively to refer to the company/asset being sold.
[2] The terms financial buyers are non-trade buyers are use indistinctively to refer to private equity or venture capital funds.

the buyer secures bank financing and cures any contingencies related to the financing (real or imaginary) - translates into a negotiation process between buyers and sellers in which the seller has given costly concession to expedite closure. BP estimates that closing a deal with a financial buyer can take as much as 50 days, against 1 week with a trade buyer. The discount over the final bid price is proportional to this delay.

Sellers are therefore interested in finding a mechanism that could remove the financing and execution risk seen in deals with non-trade buyers. SF is in principle seen as a mechanism that can mitigate this risk. Currently it is not generally used because sellers believe that SF carries more risks and costs than benefits for most deals.

Table 1 – Seller's Arguments Against and For SF

Note: The arguments in this table reflect the points of view of BP at the outset of this study

Arguments Against SF	Arguments in Favour of SF
- Conflict of interest: If SF is offered and used, the remuneration of advisors comes mainly from two sources: o Sale advisory success fees (paid by seller) - moderate, o SF fee (paid by buyer) – large. One would expect the advisor to be more interested in reaching the milestone that leads to his largest source of remuneration, i.e. SF fee. Sellers believe that the advisor would seek to push for the deal to close regardless of achieving the best sale terms to the seller. - Conflict of interest. The advisor will tend to favour buyers who have expressed interest in using the financing offer therefore limiting the number of buyers and the scope for competition. - It is unclear to sellers what drives the motivation of M&A advisors to offer SF services – are these services offered to "sweeten" the offer and therefore increase the likelihood of being awarded the advisory mandate. - If sellers decide to use SF they will need to allocate additional resources to assist the advisor to gather and process all the information required to prepare the financing package.	- Reduces the time for financial closure, therefore reducing the risk of having to adjust sale terms. Financing is one of the key hurdles in the negotiation with buyers. - Better sale terms – price and contractual commitments. The financing offer sends a strong signal to buyers that the asset is a good acquisition. Presumably this will result in better sale terms. - If financing is already attached to the asset, more buyers could be interested in the asset, consequently increasing competition and the sale price.

The purpose of this study is to further understand the mechanics of SF to provide sellers (and in particular BP) with an **independent and pragmatic** perspective of the extent to which SF can indeed add value to their asset divestments.

Because SF is a fairly recent mechanism there is no literature or statistics that could have been used as a starting point for this study. Instead, the study gathered primary information (opinions and data) from interviews with investment banks, financial buyers and BP. Gathering and compiling this information is in itself an important contribution to analysing SF. Based on this information the study presents a description of the mechanics of SF, and the motivations of different parties to use or not to use SF. The study then reviews the specific case of BP and in particular the extent to which SF could add value, and suggests a process that BP could use to analyse if SF should be used in specific deals. At the end, the study suggests a number of specific conclusions and recommendations.

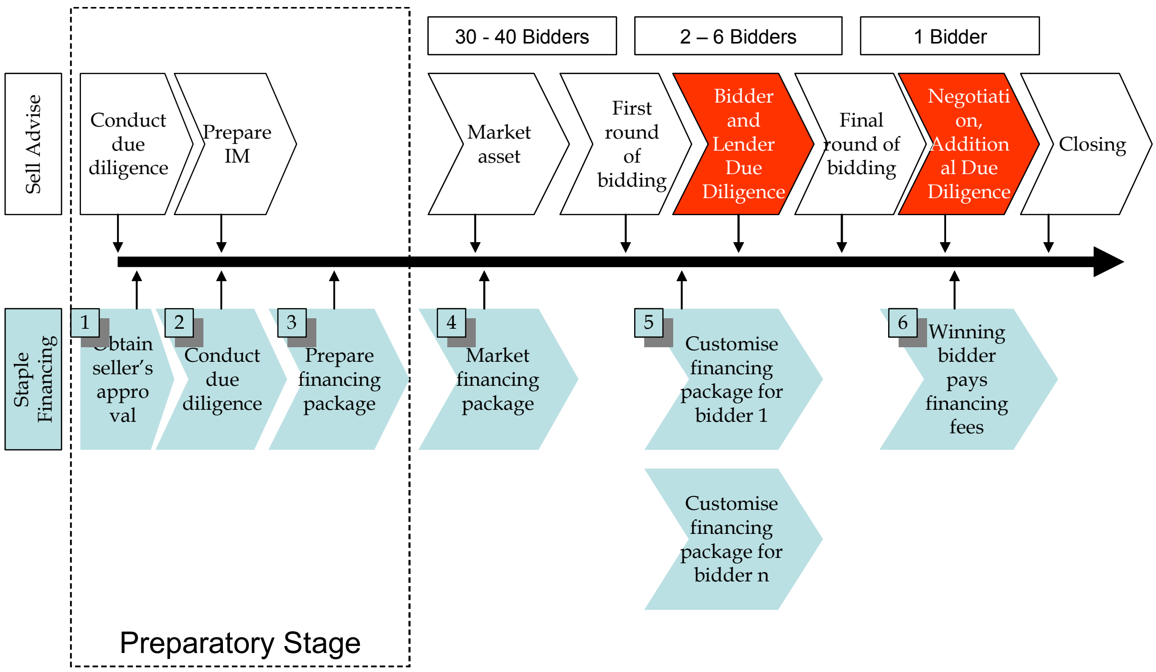
Mechanics of Staple Financing

The term staple financing refers to a situation in which the leveraged finance arm of the sell-advisory bank "staples" a financing offer to the sale information memorandum. The stapled financing package would give buyers comfort that the asset is credit worthy, and would in theory mitigate the execution risk and make the assets more attractive to the buyer.

Process for Preparing and Offering SF

The diagram below illustrates a typical SF process and its interaction with the work of sale advisors.

Figure 1 – Staple Financing Process



The top part of the diagram shows the steps typically followed by a sell advisor, the lower part the steps for the SF offer.

The process will commence when the bank with the sell-advisory mandate recognizes that the asset being sold is an attractive asset to finance. The attractiveness of offering financing depends on the size of the deal (typically more than £250M for large investment banks), the asset's credit-worthiness, if the majority of buyers are non-trade buyers, and if the sale will be on a competitive basis. Some banks have rules and criteria that they follow to decide whether to offer SF. The purpose of these rules is to preserve the reputation of the bank by avoiding the perception of conflicts of interest.

After checking compliance with all the internal rules, the sell advisor will bridge the communication between their financing colleagues and the seller. The financing team will seek to obtain agreement from the seller on the use of SF. The seller will not pay the financing team any fees. All financing fees will be paid by the buyer if it accepts the SF offer and if it succeeds in closing the deal. The seller will agree to the SF offer if it feels that the benefits outweigh the risks.

Once the seller's approval is obtained, the leverage finance team will conduct due diligence and will prepare a single financing package and draft commitment papers. If the bank were working for the buy side instead of the sell side, it would normally make a financing offer for a portion of the total debt. In the case of a SF offer, the bank will make a financing offer for 100% of the debt that the asset can hold.

It is normal for the advisory and financing teams to work together during the preparatory stage (see figure 1). These teams not only exchange information, but also work on developing an aggressive financing package that will improve the terms of the sale. In fact, banks argue that the joint work between these two teams is one factor driving the aggressiveness of the SF offer – i.e. the financing team will have a better understanding of the asset and its credit profile and would in turn be able to prepare a tailored financing offer. These advisory and financing teams will be Chinese walled once they commence their corresponding marketing activities. From this point onwards these teams have different clients and objectives. The advisory team is working for the seller and is seeking to achieve the best sale terms. The financing team is seeking to find bidders that accept the financing offer, and is developing and tailoring a financing package that maximises the value to the bidder.

To ensure a level playing field, the financing team will formally present the financing offer to all bidders. Bidders are free to use or not the financing offer. Once the first round of bidding is completed, the financing team will split into independent teams (trees) working with each of the bidders that accepted the financing offer. Each of these teams will work with the buyer to customize, modify or enhance the financing package. At this point the financing teams working with each of the bidders are competing against each other, and are in theory independent of the sell advisory team. After the deal and the financing are closed the financing team will receive its remuneration in the form financing fees.

In theory, if SF was not offered, bidder's and their lenders would conduct a detailed due diligence of the asset during the second round of bidding. In practice, however, the due diligence team of the lender will do their work only after the bidder has succeeded, i.e. after the final round of bidding. Bidders prefer to delay this due diligence to minimise the bid preparation cost and the expected loss if they do not succeed. Delaying this due diligence can be a major problem for sellers. It is possible that the buyer's lender would find credit issues with the asset that might complicate the sale. At this stage there is typically only one bidder – i.e. there is no competition – and the seller is in a weaker negotiation position (though the seller may keep the second place bidder "warm" as a back-up to mitigate completion risk with a single buyer – this strategy however weakens as the time to deliver financing is lengthened beyond expectations).

In some cases SF has been offered later during the sale process when the seller realizes that financing is a real obstacle to closing a deal; for example when the buyer or its lenders are imposing additional conditions to closing the financing. In this situation the seller can ask the financing team of the sell-advising bank to prepare a new financing offer that can be used as bargaining tool to negotiate with the buyer.

Resources, Pricing and Terms of SF Offer

Typically the financing team will consist of a multidisciplinary group of 4 or 5 professionals, depending on the size of the deal. During the preparatory stage, this team will work on the due diligence and in preparing the financing package. During the final bidding round the team will split in groups of 4 or 5 that will work in customising the financing package for each of the bidders that accepted the SF offer.

Table 2 below presents the type of fees associated with SF and advisory mandates. It also presents the absolute amounts for a hypothetical deal with a £500M sale price, 50% of senior debt and 25% of mezzanine debt.

Table 2 – Financing and Advisory Fees

	Upfront Fees	Fee (Million)
Financing Fees		
Senior Debt	2.25%	£5.63
Mezzanine Debt	3%	£3.75
Total Financing Fees		**£9.38**
Net Financing Fee Post Distribution	1 - 1.5%	**£3.75 - £5.6**
Sell Advisory Fee	0.6 – 0.8%	**£3 - £4**

Initially the SF package is offered in equal terms to all the pool of buyers. The SF package is based on the credit capacity of the asset, and is for the most part independent of the credit capacity of the buyer. As the SF package is tailored to meet the requirements of each buyer, the SF banks would check that typical credit terms are met by the newco that will own the asset.

Buyers have complete flexibility in choosing the amount of the SF offer that they want to use (0% to 100%), i.e. there are no minimum requirements. The buyer will make his financing decision based on his risk / return tolerance and expectations. There is nothing that the SF bank can do about the buyer's decision but to offer a very competitive financing package or choose not to lend.

Motivations of Sellers, Advisors and Buyers to Use or Not SF

Parties in an M&A deal have different reasons that drive their decision to use or not SF. These reasons / motivations are described in the next few pages. [3]

SELLERS - Reasons for USING SF

- **SF secures financing therefore reducing execution risk**. This risk is particularly important with a "weak" asset (i.e. when the asset has a poor credit rating), or when the debt market is tight. To support the later argument bankers argue that SF has been increasingly used during the last 3 years when the debt market has been tight. It is very difficult to test this statement because SF has not been widely used and no statistics are available.

- By presenting a financing offer at the outset of the auction, SF **reduces potential delays and the risk of having to adjust sale terms** to meet unexpected requirements of the buyer's lenders. Underlying this argument is the fact that bidders will tend to delay the lender's due diligence after the final round of bidding and the effect that this might have on the terms and duration of the sale. SF will solve this problem by removing the need for additional due diligence and for potential adverse events and delays during the final negotiations.

  A non-standard SF offer can also solve this problem by making a financing offer during the auction and letting the seller use it as a bargaining tool. A good example is the case of the recent sale of a large beer manufacturer in the UK. During the last round of bidding – with only two buyers left (private equity funds) - the seller was told by both bidders that their lenders were imposing conditions on the financing that required reviewing part of the sale terms. The sell advisory bank prepared a non-standard SF offer with the same financing terms as the buyer's banks, but without the conditions. The reaction of the bidders and their banks was to withdraw the original financing conditions.

- SF sends a signal that can **pre-set price expectations in the market and support good first round offers**. Buyers and advisors discern on the validity of this point. Bankers believe that an ex-ante financing offer sends a signal to buyers on the price expectation. Non-trade buyers will commonly decide on their initial offer price using, among other criteria, a multiple of the debt capacity of the asset. [4] A stapled financing package will have an implicit price attached to it. Buyers argue that, although their valuations are for the most part based on multiples, the SF offer

[3] The statements presented in this section were collected during interviews with BP, various large banks and private equity and VC funds.

[4] Non-trade buyers commonly make highly leveraged acquisitions. During the 3 to 5 years following the acquisition the cash flows of the asset acquired will repay part or all of the debt. At exit the equity (and consequently the return) that non-trade buyers used to acquire the asset is increased (assuming no growth) by the amount of the debt that was repaid by the asset. As the amount of debt increases, the return to equity investors increases, and the price that these investors are wiling to pay also increases. This logic holds if the terms of the debt (maturity, interest, fees, etc) remain relatively constant as the amount of debt increases.

doesn't differ greatly from the financing offer that buyers get from their own banks, and that the offer price will not be that different.

Box – 1: Private Equity Fund and VCs are Using SF to Increase Sale Price

In a market with very limited IPO exit options, some private equity funds and VCs are using SF to "squeeze" more value from the sale of their portfolio companies. These investors see SF as a mechanism that can further increase the sale price in transactions in which buyers are other private equity funds or VCs. The selling private equity fund or VC will give the advisory and stapled financing mandate to the bank that is willing to make the highest financing offer. The higher the financing offer, the higher the sale price.

Banks would compete aggressively to get the advisory and SF mandate. In fact, one of the banks interviewed explained how they recently lost a mandate because they were unwilling to lend as much as the winning bank.

This situation is clearly circumstantial. When the exit options open up for investors, and when the debt market reactivates, using SF will not achieve the same results.

The experience from the sale of a French industrial laundry business last year can be used to contradict the point of view of buyers. In the second round of bidding there were only a few non-trade buyers left, but the vendor was concerned that the bids were not credible. The sell advisor tested the bids and asserted that they were credible, but perhaps not fully valued. To enhance the value, it stapled a financing offer for a larger amount than what the bidder's banks had offered. The reaction of these banks was to increase their financing offer - this in turn increased the price that buyers were willing to pay for the company.

- SF reduces the asymmetry of financing information between the seller and bidders. With a standardised financing package for all bidders, the seller and its advisors can have a clear idea of the validity of the offers. It is not uncommon to see situations in which non-trade buyers offer high (unrealistic) prices during the first round of bidding to "scare" away trade buyers who would be willing to pay higher prices than non-trade buyers. Stapled financing sets a common denominator among which to **compare the underlying differences and realism of the bids.**

- Having a financing team conduct due diligence before the sale process enables the seller and its advisor to prepare better for the questions buyers and their lenders will ask. Also, failing to prepare upfront usually means loss of control over the timing of the process and enables bidders to find negative surprises during due diligence, leading to potential drops in price.

SELLERS - Reasons for NOT USING SF

- The major concern for sellers is the **perceived conflict of interest between the advisory and financing role**. There are two dimensions to this conflict of interest concern. First is the concern that the financing team will have access to information that the seller would rather not disclose to buyers. Second, sellers are concerned that sell-advising and buy-financing roles might have conflicting interests.

  On the first dimension, sellers typically share with their advisors sensitive information which if leaked to the buyers or their lenders could have an important negative impact on the sale price. For example, sellers are commonly reluctant to disclose all the information about contingent liabilities or the "real" EBITDA of the asset. They are reluctant to do so because they know that buyers will interpret this information in a much more radical way than sellers, and would in turn castigate their valuation and offer price. With SF, the financing team – through its interaction with the advisory team during the preparation stage - will have access to this information and could in turn share it with the buyer. In essence, **sellers are concerned that SF would decrease the asymmetry of information power** that they currently have.

  On the second dimension there are two major types of conflict of interest. First, sellers fear that the advisor will **tend to favour bidders** who accepted the financing offer. Second, sellers perceive that advisors are interested in **getting the deal through to closure (not maximising price or sale terms)** to get to the point in which they will receive the financing fees. The general response from banks is that there will be different teams working on the different sides of the deal and there are Chinese walls in between them. In practice, it is very difficult for the seller to prove that these Chinese walls exist, and the decision of the seller to agree to using SF and to ignore the conflicts of interest boils down to trust. Banks argue that maintaining their reputation is more important than the additional fees that they could get from SF, and that they will carefully weigh the decision to offer SF. Some banks have rules that constrain them from offering SF if this will have a negative impact on their reputation. One of the banks interviewed described a situation in a recent deal in which – in order to preserve the independence of the advisory and financing teams – a great deal of tension was built between the advisory team and the financing team that was working with one of the buyers during the final bidding round. These are the type of situations in which the seller fully relies on the self-discipline of the bank to maintain internal Chinese walls.

  Bankers rightly argue that at the end of the day, neither the advisory nor the financing teams have any influence over the price the seller is willing to accept. All financing can do is to offer the most competitive financing package in order to win a place on the financing for the buyer. This competition for the best financing offer increases, at least theoretically, the ability of the bidders to pay more for the business. How much the bidders pay though, is up to them.

  Banks have many relationships with both corporates and private equity houses, so in any auction ran by a Bank, they would face many conflicts. The way banks avoid conflicts is to focus on the interest of the seller and try to avoid bringing in their so-called "friends". In addition, the buyers don't choose financing banks based on relationships but rather on the merits of the offer, so allowing in "friends" in the process as a quid pro quo for financing fees does not necessarily exist as a concept.

- Vendors also see that SF **increases their work load** because they have to allocate resources to provide all the necessary information for the financing team to do their due diligence in parallel with the advisory team and prior to the bidders.

  Banks believe that the issue is the timing of when this diligence happens. Typically the sell advisor will conduct a detailed due diligence during preparation, and the buyers and their banks will conduct their due diligence during the bidding process. In theory, if the buyer accepts the stapled financing offer, there is no need for their bank to conduct another due diligence, i.e. it should save time and effort to the seller. However, if the buyer chooses the financing offer from its own banks, this bank will need to conduct its own due diligence and the time and effort the seller spends in facilitating the due diligence for the SF offer will be wasted.

  One option for addressing this issue is to have the advisory and financing teams work together in conducting the due diligence. These teams will work together in the preparatory phases to fully understand the business - at the point when the official marketing starts the teams are effectively Chinese boxed from each other.

  Some banks believe that one of the reasons that explains why a SF offer can be more aggressive than the financing offer of the buyer's banks is that SF team would have more time to conduct the due diligence. In fact, one bank mentioned the case of a recent deal in Germany in which they offered SF. Their financing offer was slightly more aggressive than that of other banks because it had the time to do a more detailed due diligence. This bank argues that in this deal SF increased the sale price by around 0.5 to 1 times EBITDA.

- In the case of assets that could significantly benefit from the marketing offered by buy-advisors, SF could have and **adverse effect on the incentives of these banks to market the asset**. In some deals, buy-side banks play a key role in using their networks and relationships to find the best buyer to whom they will introduce the deal and will later provide advisory and financing services. In the context of a deal in which SF is offered, these banks will see that part of their financing fees are at risk and will loose the incentive to actively market the asset.

BANKS - Reasons for OFFERING SF

- The main motivation for banks to offer staple financing is that they have an informational advantage and increased lead time vis-à-vis any other lender working for potential buyers and thus they have a higher probability of a successful financing mandate and greater opportunity to earn **higher expected fees**.

When banks prepare an acquisition finance package for the buyer their fees are contingent on the success of the buyer, i.e. the expected value of the fees is the amount of debt times the financing fees times the probability that the buyer succeeds in the auction. On the other hand, when the bank prepares a SF package it is likely that his expected fees will increase because instead of working with only one buyer, the bank could be working with more than one buyer, therefore increasing the probability of success. The table below presents this simple comparison for same hypothetical deal used in table 2.

Table 3 – Comparison of Buy-Side Financing and SF Fees

			Bank Working for Buy-Side - Bidder 1	Bank Working for Sell-Side – Bidder 1 and 2 Accepted SF Offer
	Probability of Success	**Net Financing Fee (Million)***	**Expected Net Financing Fee (Million)**	**Expected Net Financing Fee (Million) ****
Bidder 1	25%	£4.7	£1.2	£1.2
Bidder 2	25%	£4.7		£1.2
Bidder 3	25%	£4.7		
Bidder 4	25%	£4.7		
Total Fee			**£1.2**	**£2.4**

* £4.7 is the average net fee from table 2

** Assumes that Bidders 1 and 2 accept the full amount of SF offered, i.e. £250 Million senior debt and £125 Million mezzanine.

In addition to increasing the expected value of the financing fees, one could argue that if the bank were working for the sell side, it would not be able to independently offer financing to one of the buyers. This means that in practice the bank has the following three options: provide only M&A advice the sell side, provide M&A advice and SF to sell side, provide M&A advice and financing to buy side. The table below compares the net fees to the banks under each of these scenarios. The second seems to be the most attractive to the bank.

Table 4 – Comparison of Net Fees to the Bank

Option	Expected Net Fee (Million)
M&A Advise to Sell-Side *	£3.5
M&A Advise to Sell-Side + SF	£5.9
M&A Advise to Buy-Side + Financing Offer	£2.1

*Assuming 100% probability that the deal is closed. Average of sell advisory fees in Table 2

** (£3.5 + £2.4) = £5.9

*** (£3.5 + £4.7) x 25% = $2.1. Assumes that buyer accepts 100% of the financing offered by the bank

It is also important to understand the motivations of different individuals within a bank to offer SF. The M&A practitioner would receive a bonus based on the value of the deals closed. This person is interested in offering SF because it reduces the risk that the deal falls apart, and it could also have a positive effect on the sale price. His incentives are aligned with those of the seller. This person is building a bridge between the seller and the financing team in exchange for potential (but small) increase in his bonus. A member of the financing team receives a bonus based on the amount of financing fees that he contributed to originate. This person will try to maximise the amount of financing offered and consequently the financing fees. He has stronger incentives to work hard to develop an aggressive financing package on this deal (in comparison to working for the buy-side) because the probability that the financing fees will materialise is higher.

- Offering SF can also be attractive to banks because they can reduce the total cost of the advisory and financing mandates. The advisory and financing teams are working together during the preparatory stage and are sharing resources and information that would eventually result in a lower total cost to the bank.

- Investment banks also offer SF to **differentiate themselves from boutique M&A advisory firms** that cannot offer financing. This is particularly the case for medium size deals in which large investment banks compete with new and smaller M&A advisory firms. During the last 3 years the number of small boutique firms that offer specialized M&A increased. Initially these firms filled the segment of small deals in which large investment banks were not interested. As these new firms have grown, they compete in the middle size deal segment with larger banks. These firms have leaner personnel structures and lower overheads and are able to charge much lower fees than larger banks.

  In addition to increased competition in the middle deal size segment, large banks and boutiques compete for small deals in which the client (either in a selling of buying role) is a large corporation. Large banks would commonly have a minimum size of deal below which they won't be interested, unless the client is a very large corporation. They do this to maintain a working relationship with the client. As the number of small boutiques has increased, these firms are more aggressively offering their services to large corporations and are in fact competing head to head with large banks for small deals.

  As a point of reference, one of the banks interviewed said that they would be interested in M&A mandates for deals of more than £500M, but will make exemptions for very large clients.

- In some cases banks will offer SF before or during the bidding process if they believe that it will **increase the bargaining power of the seller**. It is unclear the real motivation of banks to offer SF in these circumstances, possibly to maintain a good relationship with an important corporate client. When SF is offered as bargaining tool, it is very uncommon for the buyer to drop the financing offer of its bank and accept the SF package. It is more common for buy-side banks to adjust their financing offer to meet the terms of the SF package. Presumably the SF banks know that the probability that its financing offer is accepted is very low, notwithstanding it is willing to carry on with the cost of preparing the financing offer.

BANKS - Reasons for NOT OFFERING SF

- **Banks would not offer SF for assets which they believe have a difficult credit history**. One of the banks interviewed said that they will offer SF only to assets that are in the "top notch" in terms of creditworthiness. The bank will make standard financing offer (commonly without any conditions) attached to the asset and needs to feel comfortable that the asset on its own is capable of sustaining 100% of the debt offered.

Some banks believe that this puts the SF bank in somewhat of a disadvantageous position in comparison to the buy-side banks. Typically a buy-side bank will be part of a syndicate and will therefore make a financing offer for less than 100% of the debt capacity of the asset. This means that the buy-side bank is not only lending less, but also has the comfort that other banks would also be on board. The SF banks, on the other hand, will make a financing offer for 100% of the debt capacity and the offer will have to be valid without the involvement of other banks. Banks would take this risk only for assets that have an excellent credit profile.

- Banks will not offer SF if they perceive that the conflict of interest associated with the SF might have a negative impact on their reputation.

BUYERS - Reasons for ACCEPTING SF

- Buyers will accept the SF offer **when the terms are as or more competitive than those offered by other lenders**. Buyers believe that this will only happen when:
  - The SF bank has the opportunity to perform a more detailed due diligence of the asset and this is reflected in the SF terms offered,
  - When the sell advisor has access to preferential information and would therefore feel more comfortable making a more aggressive offer than other banks,
  - The asset belongs to an industry in which the majority of the other banks don't feel comfortable lending. In general, for assets which are difficult to finance. This statement is in direct contradiction with the notion that bankers would only offer SF for assets that have a clean credit history.

- Buyers believe that sell advisors may tend to prefer a bidder who is using their SF package, other things being (relatively) equal. This belief is in direct contradiction with the statement that banks have Chinese walls between the advisory and financing teams. It is very difficult to prove or disprove this believe.

- Some buyers believe that accepting the SF package will give **access to preferential information and relationships** that the SF team has developed during the preparation stage of the deal. Other buyers don't buy the argument that SF adds value by bringing additional information because banks and non-trade buyers look at deals from very different perspectives. While lenders are concerned with the downside risk, non-trade buyers are concerned with the upside potential.

BUYERS - Reasons for NOT ACCEPTING SF

- Buyers are not willing to accept the SF package because they **feel uncomfortable with the SF bank working in parallel with the seller and other bidders – i.e. confidentiality concerns**. Buyers fear that confidential information will flow to other bidders, or even to the seller. However, some buyers stated that although aware of this conflict of interest, they believe that the teams are Chinese walled.

The SF bank makes a financing offer to the pool of buyers who are encouraged to accept it, but the buyers are not obliged to do so. If buyers take the financing offer, they do so knowing that it is an offer that is being made to all bidders and by the same bank that is advising the seller, i.e. they know the rules of the game.

- Sometimes buyers do not accept the SF package simply because they don't feel that the terms are attractive to them. Even if the SF package is competitively priced, buyers might not accept 100% of the financing offer, because they have a relationship with the bank that is advising them on the acquisition, and would prefer to give part of the financing mandate to this bank to maintain this relationship.

  When the buyer doesn't accept 100% of the financing offer, in theory the second lender will need to conduct its own due diligence and the benefit of SF reducing the execution time could be diminished. In practice, a second lender will "piggy-back" on the due diligence of the SF bank.

- Buyers say that they **dislike using SF because it is a "plain vanilla" offer**. Part of the competitive advantage of private equity funds and VCs comes from structuring the financing package. If they accept a standard financing offer they will lose part of their competitive advantage. In practice this argument doesn't stand because the SF package is tailored to the needs of each buyer as the auction progresses to the final round.

- Banks believe that buyers should, in theory, like SF because it sets a benchmark that buyers can use as a bargaining tool to negotiate with their lenders. However, buyers argue that getting competitive lending terms is not a problem them because they would commonly request offers from various banks and will select their lenders on a competitive basis.

SF Statistics and Trends

Although there is no public information on the use of SF, most M&A practitioners agree that is rarely used, but that in the last year is has gained popularity. The reasons underlying this trend are well explained in the previous section. The majority of the information that exists about the use of SF is anecdotal and for the most part remains exclusive knowledge of the parties that were involved in each deal. The table below summarizes the key aspects of some of the deals that used or considered SF. This table was prepared based on the information gathered from interviews with various banks and private equity funds. It is not meant to be a comprehensive list of all the deals that used SF.

Table 5 – Summary of Key Aspects of Deals that Used or Considered SF

Seller	Target	Country	Industry	Buyer	Price (Mill)	Date	SF Offer
Trivest Inc.	Aero Products Int.	USA	Air-filled bedding and furniture products	Investcorp Bank EC	NA	Completed 11/2002	Accepted by buyer
Clayton, Dubilier & Rice	Jafra Cosmetics Int. Inc	Mexico	Cosmetics marketing	NA	NA	Cancelled	Accepted by Buyer – 4.25 x EBITDA
E ON AG	Viterra Energy Services	Germany	Electric and water meter equipment	CVC Capital Partners Ltd.	$875	Completed 04/2003	Partly accepted by Buyer – 5.64 x EBITDA
Interbrew SA	Interbrew SA-Carling Business	UK	Beer	Adolph Coors Co	$1,727	Completed 02/2002	Used as bargaining tool to raise price
Elis Group	Elis Group	France	Linen cleaning services	Paribas Affaires Industrielles	$1,510	Completed 07/2002	Used to increase sale price
Odyssey Invest Partners LLC	TransDigm	USA	Aerospace components	Warburg Pincus	$1,100	Completed 07/2003	Accepted by buyer
Tyco Int. Ltd	Tyco Int. Ltd-Plastic	USA	Plastic Products	Seeking	NA	Pending	5.5 x EBITDA

The fact that SF has not been widely used shows that sellers don't see it as a major value creation mechanism and it is more circumstantial than an all-size-fits-all solution. Some of key sale conditions that will make the use of SF more likely are:

- The asset being sold belongs to an industry in which the potential buyers are non-trade buyers. Non-trade buyers would tend to buy assets that are undervalued, have a potential for a major turnaround, have large potential for growth, and / or are likely candidates for an IPO or trade-sale exit in 5 or 10 years. Typically these assets belong to industries that are facing a depression (e.g. the electricity or aerospace industries in 2001 to 2003), or to nascent industries that are expected to grow (e.g. biotechnology),

- The debt market is tight and therefore the risk of execution is compounded by the possibility that the buyer is unable (or pretends to be unable) to close on the financing for the acquisition, or
- The SF bank is able to make very aggressive financing offer that exceeds that of most other lenders. Some factors that could lead banks to make more aggressive financing offers are: they know the asset well, or they have internal core capabilities / experience that typically lead them to make more aggressive financing offers (e.g. banks in top places in the high yield league tables).

The combination of the last two factors has driven a recent increase in the use of stapled financing. First, sellers understand and recognise that stapled financing can reduce execution risk. Second, as banks see that stapled financing is more widely accepted and requested by buyers, they further push themselves to make more aggressive / less restrictive financing offers.

Case Studies

To further understand the context in which SF has been used, this section presents information on two case studies. The first case – Viterra Energy Services – is a deal closed in early 2003 in which E.ON AG sold one of its subsidiaries to Citigroup Venture Capital. The second case is a deal closed in July 2003 in which Warbug Pincus acquired TransDigm from Odyssey Investment Partners.

Case 1: Viterra Energy Services AG

Target company background: VES is a global services provider for consumption-based billing in the sub-metering and metering industry. The Company's origins go back 100 years with the foundation of Clorius in Denmark. Over the past ten years, VES has developed into a leading international services company providing metering and sub-metering services in more than twenty countries, servicing more than 300,000 customers, over 500,000 properties and 10.5 million dwellings based on medium and long-term contracts. In most of its markets, the Company holds the leading market position - in its biggest market, Germany, it holds a close number two position.

Seller: E.ON AG - Europe's largest publicly listed energy service provider active in areas including electricity, oil and chemicals.

Buyer: CVC Capital Partners – Independent multinational buy-out firm managing over US$8 billion in equity capital and with over 230 investments with a total value in excess of US$40 billion.

Sell Advisors: Goldman Sachs & Co

Buy Advisor: UBS Warburg

Consideration: €845M

Sources of Funds:

Sources of Funds	(€m)	% Cap.
Term Loan A	180.0	20.6%
Term Loan B	135.0	15.4%
Term Loan C	135.0	15.4%
Total Senior Debt	**450.0**	**51.4%**
Mezzanine Facility	197.5	22.6%
Total Debt	**647.5**	**74.0%**
Equity	**227.5**	**26.0%**
Total Sources	**875.0**	**100.0%**

The debt was underwritten by CIBC World Markets plc, Goldman Sachs International and Bayerische Hypo- und Vereinsbank AG. CIBC and GS initially underwrote the entire debt transaction and then brought in HVB.

Sale Drivers: E.ON is transforming itself from a conglomerate into a multi-utility and consequently it is in the process of acquiring other utilities and selling non-core operations (i.e. Viterra) to focus on its utility businesses and to raise cash for acquisitions. Viterra's revenue in 2001 was less than 2% of E.ON's, i.e. it was a relatively small operation for E.ON.

***Buy Drivers*:** CVC believed the acquisition represented an attractive opportunity to generate significant value. This deal met the typical investment criteria of a leading European private equity house: platform for further growth, stable cash flows with a significant portion of long-term contracted revenues, favourable market dynamics with consumption based billing addressing higher energy prices and environmental issues, well established customer relationships in key markets, and experienced and motivated management team.

***SF Offer*:** When Goldman Sachs (GS) was pitching the sell-side mandate it realised that offering SF was a reasonable option because most of the interested buyers were financial buyers and because Viterra had an excellent credit profile. GS introduced the SF concept to E.ON and Viterra counterparts. After obtaining approval, GS obtained the necessary internal credit checks, conducted due diligence and prepared a €680M SF package. The advisory and financing team worked together during the preparation of the information memorandum and financing package. After the first bidding round, these teams were chinesed walled, with the financing focusing on marketing the SF offer with the pool of buyers. The two buyers left during the final round accepted the SF offer and GS established trees of teams to work independently with each buyer to tailor and negotiate the specific terms of the financing offer. GS believes that they were able to offer an aggressive financing package because they had more time (than the buyer's lenders) to conduct a thorough due diligence and to prepared a customised financing package.

Estimated Fees: Advisory fees Advisory + Post Distribution Financing Fees to GS: €7 to €10 million

Reasons for Advisor to offer SF: Offering SF in this deal was attractive to GS for the following reasons: the size was attractive, buyers were non-trade buyers, the business had a clean credit history and would accept a high leverage ratio, and most importantly because SF would significantly increase the expected fees.

Benefits of SF to Seller: It is difficult to isolate the specific value that SF delivered to E.ON. The sale of Viterra delivered to E.ON a much higher multiple to book value than divestments that preceded Viterra - Viterra delivered a gain of €700M over a sale price of €930M while the sale of Schmalbach-Lubeca (a German packaging sold by E.ON in 2002) delivered a gain of €550M over a sale price of €3,000M. There are many factors that can affect this difference, and SF could be one of them.

GS estimates that SF added 0.5 to 1 points to the EBITDA multiple., but providing hard evidence to support this number is almost impossible.

Benefits of SF to Buyer: The buyer believes that the opportunity for a highly leveraged acquisition was a key reason to pursue this deal. Viterra has a stable cash flow that sustains a higher than average leverage. The buyer believes that the return on this deal will not come from aggressive growth or cost cutting, but from repaying debt and from an IPO exit in 3 to 5 years.

It is unclear however the extent to which SF led the increase in leverage that would ultimately attract/benefit financial buyers. While GS argues that its financing offer was more aggressive than offers made by other lenders; the buyer claimed that the debt market is sufficiently competitive to lead to aggressive financing offers without having to rely on SF. SF might contribute to the aggressiveness of an offer as a result of a more comprehensive due diligence, but there are other key factors that affect the ability of a bank to stretch its financing offer, e.g. banks ranked at the top of high yield league tables are known to be more aggressive lenders. In the case of Viterra, the buyer accepted part of the SF offer because it had competitive terms and because it also added strategic value (e.g. relationships).

Case 2: TransDigm Inc

Target company background: TransDigm is a leading manufacturer of highly engineered component products for the commercial and military aerospace industries. The company sells its products to the commercial OEM and aftermarket customers. The Company is a holding company with five subsidiaries: Aero Controlex Group, AdelWiggens, Marathon Power Technologies, Adams Rite Aerospace, and Champion Aerospace. The company was acquired by Odyssey Investment Partners in 1998 for $125M. After the acquisition Odyssey made a series of add-on acquisitions to help bolster the company. Among those deals, Odyssey bought for $177.5M Champion Aviation Products. In December 2002 TransDigm had $260M in revenues and EBITDA margin of 40%. Its profitability has increased during the last two years in spite of the depression of the aviation industry.

Seller: Odyssey Investment Partners is the manager of a $760M private equity fund engaged in making investments primarily in established middle-market companies in a variety of industries. Odyssey focuses on three core sectors: industrial companies, communications and financial services. Odyssey has a long history of successful aerospace investments, including TransDigm, Aeronautic Development Corp., Tri-Star Aerospace Company and Specialty Avionics Group, which it recently acquired from DeCrane Aircraft Holdings Inc.

Buyer: Warburg Pincus has approximately $8Bn under management and $6Bn available for investment globally in a range of sectors including industrials and chemicals, energy and natural resources, financial services and technologies, healthcare and life sciences, information and communications technology, media and real estate.

Sell Advisors: Credit Suisse First Boston and Wachovia Securities Inc.

Buy Advisor: Citigroup

The deal and sale process: Warburg Pincus and senior members of management acquired the company from Odyssey. The sale process was highly competitive with bids received from Thomas H. Lee Partners, Aurora Capital Group and a consortium comprised of Berkshire Partners, Weston Presidio Capital and Greenbriar Private Equity.

Consideration: Approximately $1.1Bn

Sources of Funds: The acquisition was financed with a combination of debt and equity. The total debt of the business (post-acquisition) was 5.5 x LTM EBITDA. Exact figures on debt instruments and equity injection were not available.

Sale Drivers: Odyssey felt that this was the right time to exit, and that a trade-sale would be the best option. Without disclosing its return on investment, Odyssey felt that investment in TransDigm generated an attractive return.

Buy Drivers: The motivation of Warburg Pincus in buying TransDigm is to further grow the company and eventually take it to an IPO exit in 3 or 5 years. The company is an attractive acquisition because although it has been profitable in the past, it belongs to a depressed industry with a huge upside from the expected recovery of the global economy. The company also has a strong management team with a proven track record.

SF Offer: The CSFB M&A team decided to offer SF when they realised that there was a high probability of selling to financial buyers. After Odyssey agreed to CSFB offering SF, the stapled financing and advisory teams worked together in preparing the information memorandum and financing package. The stapled financing team marketed the SF offer with the pool of buyers, some of which decided to use the financing offer. Trees of execution teams were later created to work with each of the buyers that accepted the financing offer. Each of these teams tailored the financing package to the needs of each buyer. According to CSFB conflicts of interest were not an issue in this case because the goals of the financing and advisory team, as well as the seller, were aligned. The advisory team and sellers were interested in maximising the sale price, and the financing team was interested in maximising leverage, which would in turn have a positive effect on price. CSFB had a good trust relationship with the seller, which in turn mitigated conflict concerns by the seller.

Estimated Fees: Advisory fees between $7M and $10, and financing fees between $17M and $20M.

Time table: Total time from announcement to closure = 6 weeks – record time.

Motivations of Advisor to offer SF: CSFB decided to offer SF because it would have a positive effect on the sale price without upsetting the long-term relationship with the parties involved in the deal. CSFB also believed that in this particular deal they were well positioned to get the acquisition finance mandate because they knew the target and seller well and because they have a reputation for being an aggressive player in the high yield market.

Benefits of SF to Seller: It is difficult to determine what specific value did SF add to Odyssey. An aggressive financing package would certainly have a positive effect on the sale price. Did SF led CSFB to offer an aggressive financing package, or could they have offered this same package if they were working directly for the buy side? The conditions that led to an aggressive offer seem to be more related to CSFB's knowledge of the asset and CSFB's core capabilities/experience as a bank in offering aggressive financing, and not to the fact that it was part of a SF package. On the other hand, the aggressive SF package offered by CSFB defined a baseline that all buyers could use to challenge their lenders, and that the seller could use to send a price signal to buyers which would in turn increase competition among buyers. If CSFB was working for the buy-side (i.e. with only one buyer), only this buyer would benefit from this offer, and the aggressive offer will have no impact in increasing competition among buyers.

In addition to its possible effect on price, SF also contributed to reaching closure in a record time of 6 weeks. SF contributed to reducing the time to closure by eliminating the need for the lender's due diligence during or after the final round.

Benefits of SF to Buyer: All buyers had access to an aggressive financing offer that would have a positive effect on their returns. Buyers could either accept the SF offer or use it to challenge the offers presented by their lenders.

Quantifying Value Added by SF

One reason why BP would decide to use SF is because the value that it adds to its asset divestments is greater than the direct or perceived costs of using it. This section suggests the main reasons why SF could add value to BP's assets divestments and proposes a method for quantifying this value.

Based on the experience of the deals reviewed as part of this study, one can suggest two fundamental reasons why SF could add value to BP's asset divestments. First, SF reduces the risk that the BP will be forced to negotiate down the price or sale terms to meet financing conditions supposedly imposed by the buyer's lenders (i.e. it reduces the bargaining power of buyers); and second, SF banks typically offer more aggressive financing terms than other acquisition finance banks for the same target and buyer, therefore increasing the price that financial buyers are willing to pay for the asset. The rational behind this suggestion, a proposed method for estimating this value and some evidence supporting this suggestion are presented in table 6 below.

BP's initial reaction to the empirical reasons suggested in the previous paragraph was of disagreement. BP believes that on average or good deals competitive tension among multiple bidders limits exposure to downward price revisions by buyers, thus the time and expense of SF is unnecessary. In addition, perceptions of potential conflicts of interest further erode support for SF where assets are perceived to have average to above marketability. On the other hand, in the case of difficult deals, e.g. deals in which raising acquisition finance can be a serious problem, the value-added by SF from facilitating the sale can offset the perceived conflicts of interest. In fact, BP would be may be willing to entertain the option of paying part of the SF financing fees or preparation costs to make difficult assets more "sellable". A further discussion on this argument is presented in table 7.

Both tables 6 and 7 suggest a process for estimating the value added by SF. A logical next step to this study would be to test the process with several BP case studies.

Table 6 – Sources of Value Added to BP When Using SF – Empirical Perspective.

Reason	Rational	Estimate Impact / Value Added	Evidence
SF reduces the risk that BP will be forced to negotiate down the price or sale terms to meet financing conditions imposed by the buyer's lenders.	In practice it is common for buyer's lenders to conduct their due diligence after the final bidding round. It is possible that this due diligence reveals issues of the target which make the lender impose conditions to the acquisition or adjust the terms of the sale. The price and terms of sale will most likely be adjusted against the interests of BP. If SF is offered from the outset, the financing package offered already incorporates the results of the due diligence. Therefore SF mitigates the risk of finding new financing conditions after the final bidding round to adjust the price or sale terms. It is not uncommon for financial buyers to piggy-back on the due diligence of their lenders to introduce their own conditions to closing the deal. Without the financing pretexts, financial buyers have less leverage to further introduce conditions.	The impact (value added) of SF to BP in mitigating this risk is equal to the loss in value that BP would have otherwise taken if they had to adjust the price or sale terms to meet the financing conditions imposed by the buyer's lenders. Calculating this loss ex-post and estimating it ex-ante are difficult tasks. To calculate it ex-post one would need to: i) identify the deals in which post-auction negotiations have resulted in downward adjustments to the price or sale terms; ii) review the terms of the negotiations to identify those specific terms that originated from conditions imposed by the buyer's lenders; iii) determine / estimate the value to BP of each of these elements; iv) the sum of these values is the total loss in value to BP resulting from financing conditions. In order to develop a rough estimate of	1. BP estimates that on average or above average assets sold to private equity buyers the closing price was discounted by 0 to 5% during post auction negotiations. Part of this discount comes from conditions imposed by the buyer's lenders. However the value of assets that BP sells to private equity is relatively small in comparison to its $5bn/year asset sales. 2. In the sale of Carling Beer ($1.7Bn) the sell advisory bank (GS and LB) prepared a non-standard financing offer with the same financing terms as the buyer's lenders, but

		the expected loss in value ex-ante one could: i) identify common factors that were present in deals in which downward post-auction adjustments in price and sale terms occurred as a result of conditions imposed by buyer's lenders, e.g. these factors can include: existence of contingent liabilities, limited competition, risky cash flows, etc.; ii) based on the ex-post calculations of loss in value, create two or three categories with low, medium and high losses, e.g. low losses might be between 0% and 2% of offer price; iii) identify the correlation between each of these categories and the common factors identified to create a scale in which ex-ante information about the factors can lead to a rough estimate of the expected loss in value; iv) use this scale and the specific factors of a deal to estimate the expected loss in value.	without the conditions. [5]This SF offer forced banks to remove the lending conditions.

[5] Pseudo SF means that the seller goes through the motions of getting agreement to a financing offer from the sell-advising bank as a negotiating tactic when the buyer pretends that his bank is being difficult

SF offers typically have more aggressive financing terms than other acquisition finance offers for the same target and buyer.	Banks are inclined to make a more aggressive financing offer under a SF deal than under a normal acquisition deal for the following reasons: - a higher expected hit ratio increases the commitment of the bank. Higher commitment results in more resources allocated to preparing the financing offer and a more detailed analysis of the creditworthiness of the target. A more detailed analysis leads to preparing a more tailored financing package which better matches the credit profile of the target, and is in turn more aggressive than a standard financing offer. As lenders analyse the target's credit in greater detail they are able to remove safety margins that they would typically include in lending operations in which they don't have the time or commitment to analyse the credit in the same level of detail. - In addition to being more committed, SF banks would normally have more time to conduct the due diligence. This gives SF banks the ability to get to know the asset better and prepare a more tailored financing offer. Typically an acquisition bank would	The impact (value added) to BP of a more aggressive financing offer is an increase in the price that financial buyers are willing to pay for the target. Underlying the above argument is the fact that private equity or venture capital buyers commonly determine the offer price as a multiple of the debt capacity of the target. A more aggressive financing offer in this case is understood as an offer in which the SF bank is willing to lend more than other banks at roughly the same terms (interest rate, maturity, fees, etc.). Assuming that buyers will transfer the entire additional debt offer to their price offer, one can compute the value added by SF to BP (i.e. increase in offer price) simply as multiple of the difference between the amount of debt offered by SF banks and that offered by other banks. Ex-post, the value added can be computed by collecting information on financing terms offered by SF and acquisition banks on deals that used SF.	SF Banks speculate that in previous deals SF has added between 0.5 to 1 points to the EBITDA multiple. In the sale of Elis Group in France, the sell advisor stapled a financing offer for a larger amount than offered by the buyer's lenders. The reaction of the buyer's lenders was to increase their financing offer - this in turn increased the price that the buyers were willing to pay for the company

	Typically an acquisition bank would have a week or less to conduct their due diligence (depending on the complexity of the target) while a SF bank would have 2 to 3 weeks for the same type of deal. - Banks that currently offer SF are the same banks that traditionally have been the most aggressive in the acquisition financing market.	This information could potentially be obtained from financial buyers or from SF banks. Based on the ex-post value added calculation, one could say that SF adds a range of premiums to the non-SF offer price. There are some characteristics of the deal or target that determine where would a target fall in this premium range. These characteristics could include the credit profile of the target, the extent of competition to provide financing or to acquire the target, the size of the deal, or the business relationship with BP, among others. SF banks know which are and how important are these characteristics to them. In order to estimate the value-added ex-ante one would need to relate the characteristics of the target to those that historically have influenced the extent of value added. For example the ex-post analysis might show that SF banks tend to make the most aggressive financing offers (e.g. 15% higher than acquisition banks) in deals in which the target company has stable cash flows,	

		low leverage, there is fierce competition to provide financing and to acquire the asset, and BP is a very large corporate with whom the bank has a longstanding working relationship. On the other hand one could also find that SF banks are not willing to make an aggressive SF offer if the deal characteristics are on the flip side of those described above. With an understanding of how these characteristics influence the aggressiveness of the SF offer, one can use the historical data to make a rough estimate of how much value one can expect for a specific deal based on its characteristics.	

Table 7 – Sources of Value Added to BP When Using SF – Theoretical Perspective.

Reason	Rational	Estimate Impact / Value Added	Evidence
SF could increases the attractiveness of "difficult" to sell targets.	BP sees more value in using SF for targets that are either difficult to sell because of their credit profile. At the same time, buyers also see that SF can be more attractive to them in the case of targets in which raising financing at reasonable prices could be difficult. Banks however, are less interested in offering SF for difficult to finance targets.	There are no examples identified as part of this study of deals in which SF was used to facilitate the sale of difficult asset, i.e. there is no historical data to calculate the value added by SF. However, BP has been involved in several deals in which SF could have facilitated the sale and potentially increased the closing price. In these deals the amount of value that SF could have added is equivalent to all or part of the loss in value to BP, i.e. the difference between the closing price and the sale price originally estimated by BP. The loss in value depends on the characteristics of the target, and similar to the process described above, one should be able to establish some correlation between the loss in value and the key characteristics of the target. Based on this correlation, one could estimate ex-ante the value added.	BP estimates that on difficult deals the closing sale price can be discounted by 5 to 30% to respond to financing/return needs and expectations of buyers. The discount can change greatly if the asset is sold with a competitive auction or not.

Checklist for Deciding When to Use

Beyond the argument of how much value can SF add to BP, one should also analyse other factors that make SF a feasible proposition in any deal. We've seen what factors motivate advisors, sellers/BP, and buyers to use or not SF. BP's decision to use SF in a specific deal should consider the extent to which the characteristics and circumstances of a specific deal respond to these factors.

The author developed a checklist that gives BP a framework for analysing this responsiveness. This checklist can help BP do a preliminary screening. The actual decision to use SF will depend on a further examination of the costs and benefits. The checklist is presented in Table 8. It is divided in three sub-checklists: banks, BP and buyers. Each of these sub-checklists has specific criteria that reflect the factors that motivate each of these parties. The logic behind the checklist is that it is worth analysing SF in more detail if it responds to the key factors that motivate each party. Each specific deal is measured against each criterion on scale from 1 to 5. The meaning of this scale differs for each criterion and is explained in table 8. It would make sense for BP to further analyse the benefits of SF if the deal receives a total score greater than 17 points. This minimum level was set based on information provided by each of the parties during the interviews or from the judgement of the author based on his interpretation of the motivations of each party. This minimum score should be further calibrated when testing the methodology.

Sub-checklist for Banks

Banks would base their decision to offer SF primarily on four criteria: scale of deal or client, type of buyers (i.e. non-trade buyers), creditworthiness of asset, and likelihood of increasing hit ratio. The minimum score that represents a deal in which banks would be motivated to offer SF is 14 points. The minimum scores for each criterion are highlighted in table 8.

Sub-checklist for BP

BP would be motivated to use SF if the value that SF creates is greater than its perceived costs, i.e. the costs of the conflicts of interest. The previous section of the report explained how BP could estimate ex-ante the value that SF creates. This value comes from a sale premium, or from avoiding a loss associated with selling a difficult asset or with entering into post-auction negotiations with the buyer's lenders. Table 8 measures this value as a premium over the non-SF price, or as a percentage loss over the price originally estimated by BP or its advisers.

The cost to BP of the perceived conflicts of interest is very difficult to quantify. Rather than developing a complex methodology to estimate these costs, the author decided to use a scale in which BP would exercise its judgment on the importance of the conflicts of interest. It is not only very difficult to measure this cost, but any measurement would be based on major assumptions that would not be much more accurate than an expert judgement.

The values of the conflicts of interest scale are negative to offset the positive scores of the value-adding criteria. In setting the minimum score for this category the author assumed that SF could add value only in one of the three criteria indicated in table 8, i.e. 2.1, 2.2, or 2.3. The scales set for each of these criteria are based on the judgement of the author. Based on the above logic and scales, the minimum scale for this sub-checklist is zero.

Sub-checklist for Buyers

The motivation of buyers to use SF is primarily driven by the attractiveness of the SF offer. This attractiveness can be measured as a premium over the financing offers made by other competing banks. The premium is the difference between the total debt offered by the SF and the total offered by the competing banks. For simplicity, this measure assumes that all the other financing terms are equal.

The scale and minimum score (3 points) for this criterion was based on the author's judgement.

Table 8 – Stapled Financing Score Card

1 Sub-checklist for Offering Banks

Deal Size	£250M £300M	£300M £400M	£400M £500M	£500M £600M	>£700M
	1	2	3	4	5
Client Size	Small client		Medium client		Very large client
1.1 Is the deal of a sufficiently large scale or for a large client?	**1**	2	3	4	5
Why? - The banks that typically offered SF are only interested in lending operations of more than £250million, unless it is for a large corporate client (seller)					

% of Trade Buyers	<40%	<30%	<20%	<10%	0%
1.2 Are the majority of the potential buyers financial buyers?	1	2	**3**	4	5
Why? - Financial buyers are more likely to make a highly leveraged acquisition in which SF can add value.					

Measure of Asset's Credit Profile	Poor				Good
1.3 Is it an asset with an attractive credit profile?	1	2	**3**	4	5
Why? - The bank will make a standard financing offer (commonly without any conditions) attached to the asset and it needs to feel comfortable that the asset - on its own - is capable of sustaining 100% of the debt offered. Typically banks would feel comfortable with top notch assets.					

	Percentage increased in expected fees	0%		50%		>100%
1.4	Is SF likely to increased the hit ratio and expected fees to the bank? *Why? - SF would increased the expected fees if the financing package is sufficiently aggressive to make it attractive to buyers. The aggresivness of the SF package depends on the commitment of lenders and the credit profile of the asset.*	1	2	3	4	5

2 Sub-checklist for BP

	Estimated sale price premium from SF	0%		5%		>10%
2.1	How much is SF expected to add as a premium to the sale price? *Why? - As explained in table XX, one of the ways in which SF adds value to sellers is by offering an aggressive financing package that would results in a higher offer price*	1	2	3	4	5

	Estimated loss avoided from SF	0%		5%		>10%
2.2	How much loss is SF expected to avoid from post-auction financing negotiations? *Why? - As explained in table XX, one of the ways in which SF adds value to sellers is by mitigating the risk that the seller will be forced to negotiating down the price or sale terms to meet financing conditions imposed by the buyer's lenders.*	1	2	3	4	5

	Estimated loss avoided from SF	0%		20%		>30%

2.3	How much loss is SF expected to avoid in the case of difficult to sell asset? *Why? - As explained in table XX, one of the ways in which SF adds value to sellers is by increasing the attractiveness of "difficult" to sell assets.*	1	2	3	4	5

	Degree of importance	Little		Moderate		Very
2.4	How important are SF perceived conflicts of interest in this deal for the seller? *Why? - Sellers are commonly reluctant to use SF because it carries conflicts of interest. The degree of importance of conflict of interest change from deal to deal*	-1	-2	-3	-4	-5

3 Sub-checklist for Buyers

	Estimated borrowing premium from SF	0%		2%		>5%
3.1	Is SF offering a more aggressive financing package than other acquisition financiers? *Why? - In highly leveraged acquistions the return to financial investors at exit increases with leverag,i.e. financial investors are more likely to accept SF if it offers more debt than other lenders.*	1	2	3	4	5

Conclusions and Recommendations

This research study was originally designed to analyse the extent to which SF effectively adds value to sellers in M&A transactions, and in particular to the case of BP. BP has not used SF in the past because it believes that the costs of perceived conflicts of interest outweigh the benefits. The study focused on exploring this rational and finding evidence that supports or denies it.

Because very little publicly available data or information exists on SF, the study initially focused on an extensive primary data gathering effort. This data indicated that:

- SF has been rarely used in M&A transactions, but in recent years it has gained popularity,
- Only advisors/banks are keen to use SF – the benefits to them are directly measurable and significant. Although sellers are now more aware of its benefits in reducing execution risk and are more proactively requesting it,
- SF added the most value to sellers when it is used in a non-standard form, e.g. as bargaining tool.

Initially the majority of the instances in which SF was used were deals in which the bank offered it, and not in which the seller requested it. This implied that in general the view of sellers was that the costs (principally the opportunity cost of the time and resources to support financing due diligence) of SF outweigh its benefits. As sellers have gradually recognized the benefits of using SF to reduce execution risk, they have been more proactively requesting it.

The circumstances for its value-adding use by a seller appear to limited and difficult to isolate and measure. These circumstances include:

- sharing critical information with the SF bank is not too costly,
- competition among bidders will not take care of financing problems,
- either the bargaining situation can be improved by negating attempts by the buyer to use pressure from his bank as an excuse, or problems that the buyer has in financing the deal can be overcome in a way that is not possible to do by sharing more information on a selective basis with the buyer and his bank.

This set of criteria is likely to make the decision to use SF rather specific, so the idea that a general purpose 'one-size-fits-all' tool like standard SF is not likely to be a solution.

Therefore, the conclusion is that the tactical use of the seller's bank in a flexible way to improve negotiations in the sale of assets is sensible, but that standard SF is unlikely to be a panacea solution.

Further to this conclusion, the author developed a checklist to screen the deals in which SF might add value. The logic behind this checklist is that SF is a relevant proposition for a specific deal if it responds to the motivations of each party. Part of this checklist involves estimating the benefits to BP. Benefits can be estimated by measuring the impact that SF could have in a specific deal. The author also developed a methodology for measuring this impact. Following the development of these methodologies, the author recommends a follow-on research study that tests these methodologies with a couple of BP case studies.