

2010 M&A HOLDBACK ESCROW REPORT

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# Executive summary

## Overview

### **Background and scope**

- J.P. Morgan Escrow Services is conducting an ongoing study of data points pertaining to holdback escrow accounts used in merger and acquisition transactions
- The data is based on J. P. Morgan escrow transactions with publicly available acquisition information that originated in the United States between July 2008 and December 2009<sup>1</sup>
- Sample size: 142 transactions out of 516 holdback escrows closed by J.P. Morgan during this timeframe<sup>2</sup>

### **Objectives**

- To offer holdback escrow transaction benchmarks
- To provide insight into the outcomes of holdback escrows

## Summary of key findings

### **Escrow deposit size**

- The average cash deposit size was \$4.88MM; the median cash deposit size was \$1.65MM
- The average percentage of purchase price placed in a cash escrow account was 10%

### **Escrow lifespan**

- The average expected duration of escrow accounts was 19 months

### **Claims**

- 30% of all terminated deals had at least one claim
- Purchase price adjustments and working capital adjustments were the most common claim reasons, followed by representations and warranties

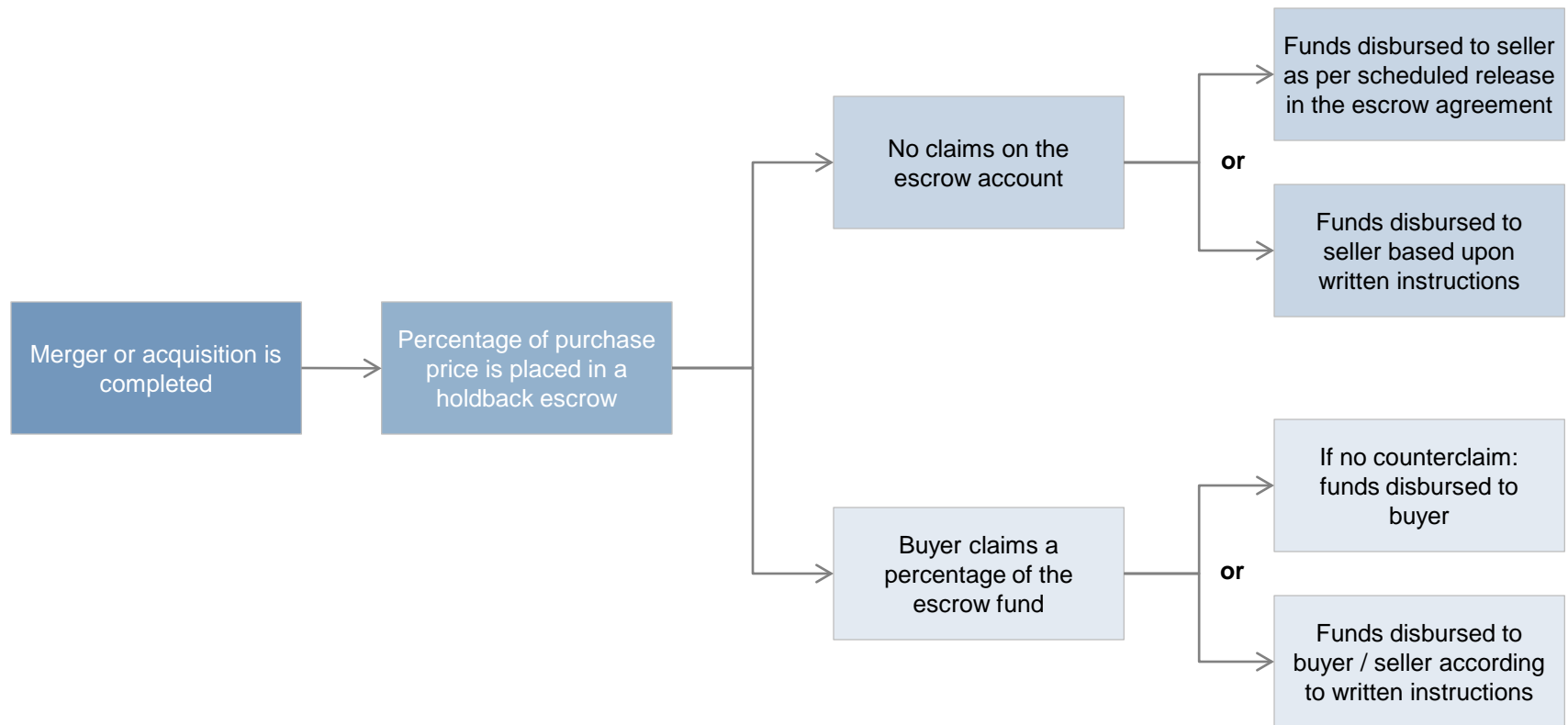
<sup>1</sup> "Publicly available acquisition information" is defined as the availability of transaction details in the Capital IQ database: <https://www.capitaliq.com/>

<sup>2</sup> Note that population sizes vary for particular data points due to availability or applicability of information

# Overview of the holdback escrow process

## Holdback escrow definition

- At the closing of a merger or acquisition, a portion of the purchase price is placed in an escrow account and held until the terms of the escrow agreement have been satisfied
- Holdback escrows serve as a risk mitigation tool: the claims process provides the buyer with an opportunity to retrieve the funds in escrow in the event that the seller fails to meet specific terms of the sale and purchase agreement



# Characteristics of the underlying mergers and acquisitions<sup>1</sup>

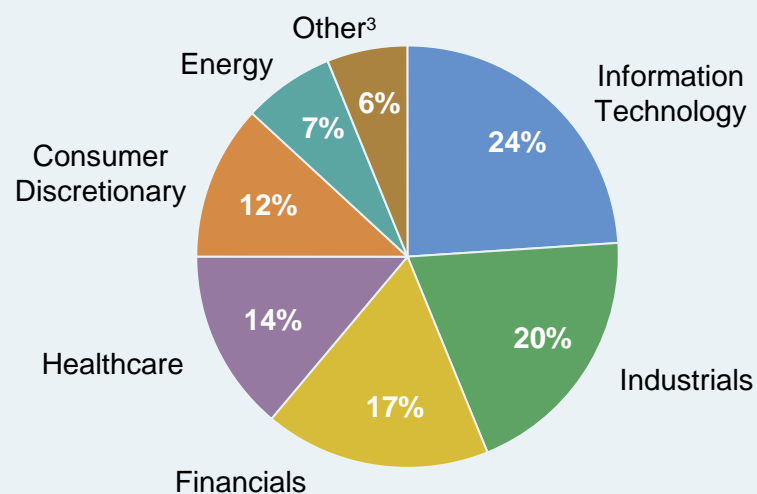
## Transactions: Financials and features

- Financials
  - Transaction size<sup>2</sup>
    - Average: \$104MM
    - Median: \$50MM
    - Range: \$0.3MM – \$810MM
  - 55% of deals were funded through multiple sources (i.e. cash, stock, debt, etc.); 45% cash only
- Nature of the deal
  - Buyer acquired both a majority stake and control of target in 99% of transactions
  - 91% of deals were unsolicited; 9% solicited

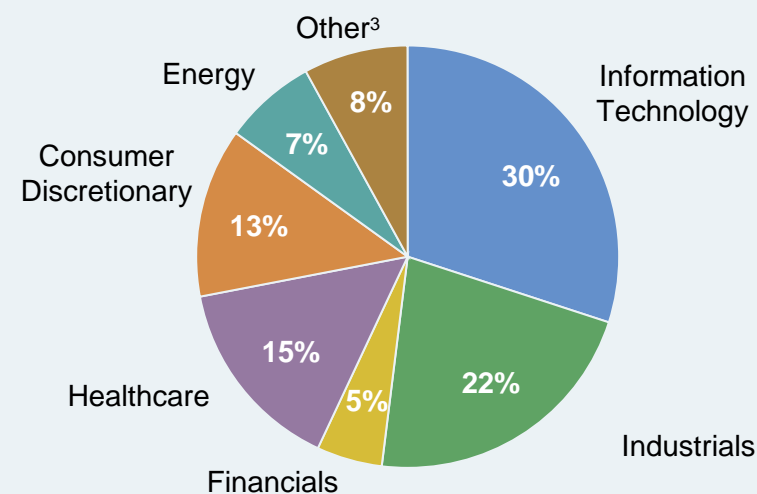
## Counterparty classification

- Counterparty type
  - 63% of buyers were private companies
  - Targets were either a private company or an asset / product of a private company
- 13% of all transactions were cross-border

## Buyer sector breakdown



## Target sector breakdown



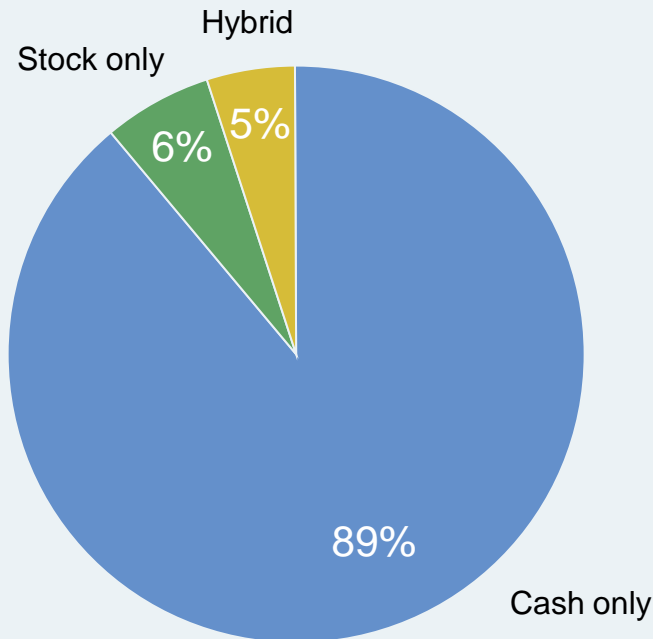
<sup>1</sup> Sourced exclusively from available information in Capital IQ

<sup>2</sup> Transaction size is defined as the "Total Gross Transaction Value", less earnouts (per Capital IQ definition)

<sup>3</sup> "Other" consists of the following sectors: Consumer Staples, Materials, Telecommunication Services and Utilities

# J.P. Morgan escrow deposits

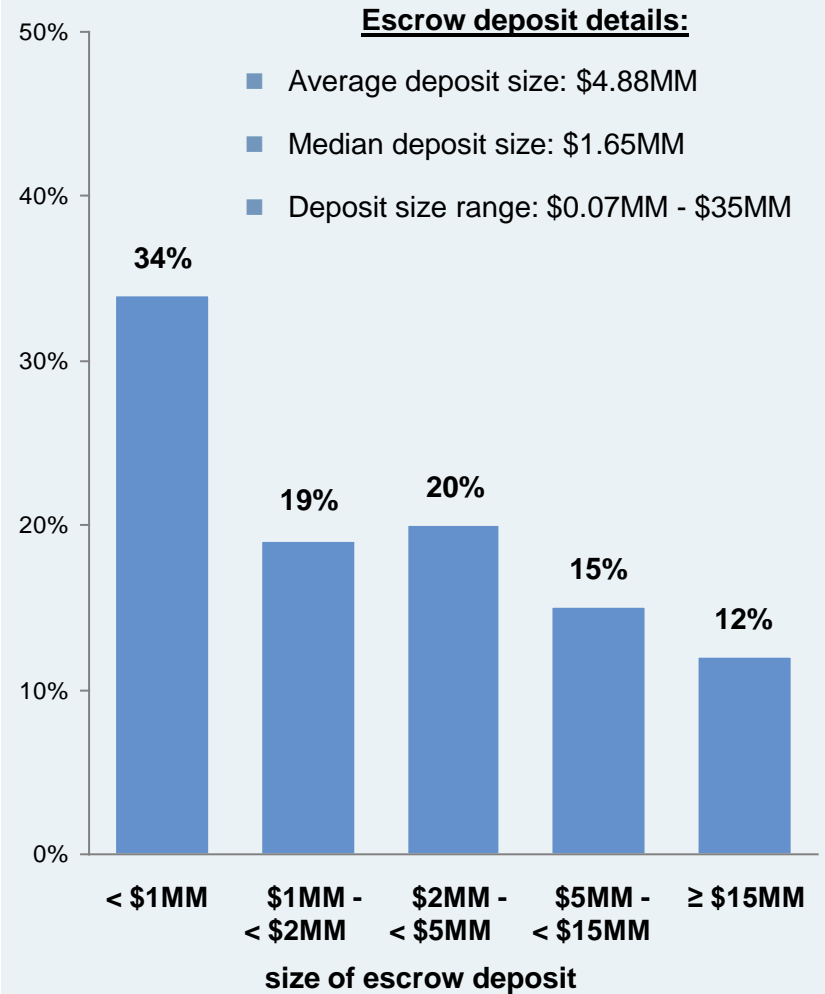
## Escrow deposit components



### Account structure:

- 11% of escrow agreements call for multiple accounts to be used for distinct purposes
  - Most common arrangement requires two accounts
    - One typically designated for “Purchase Price Adjustments” or “Working Capital Adjustments”
    - The other for general indemnification purposes

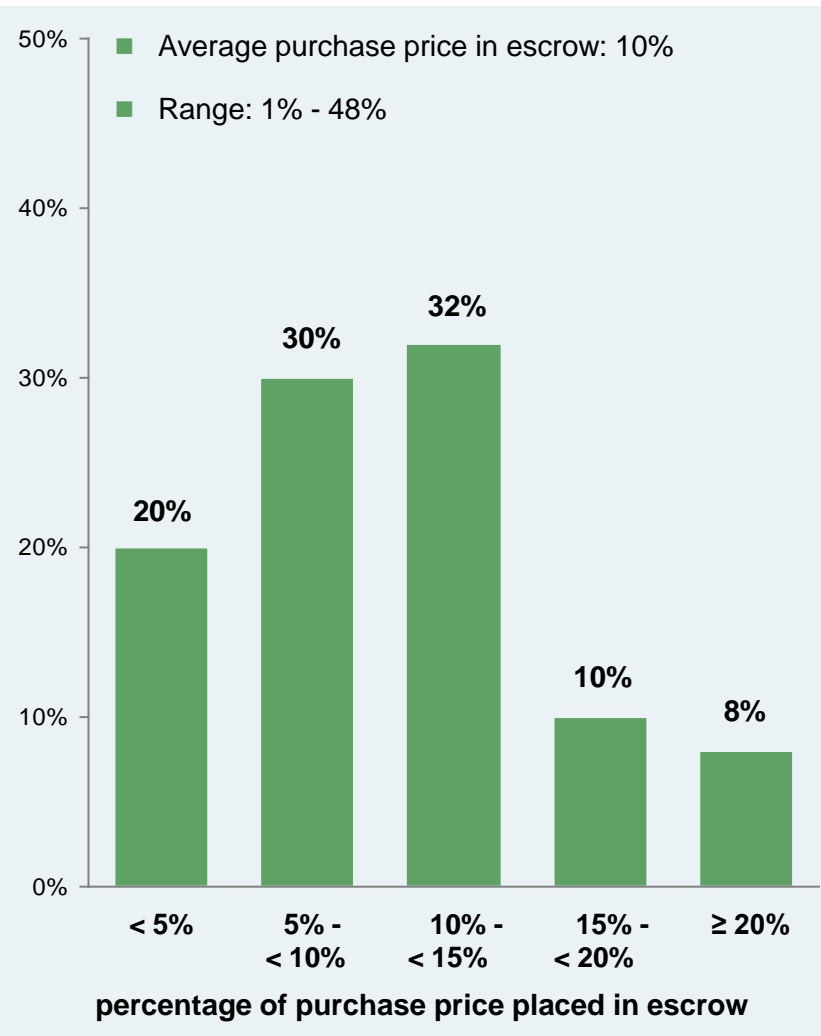
## Escrow deposit size<sup>1</sup>



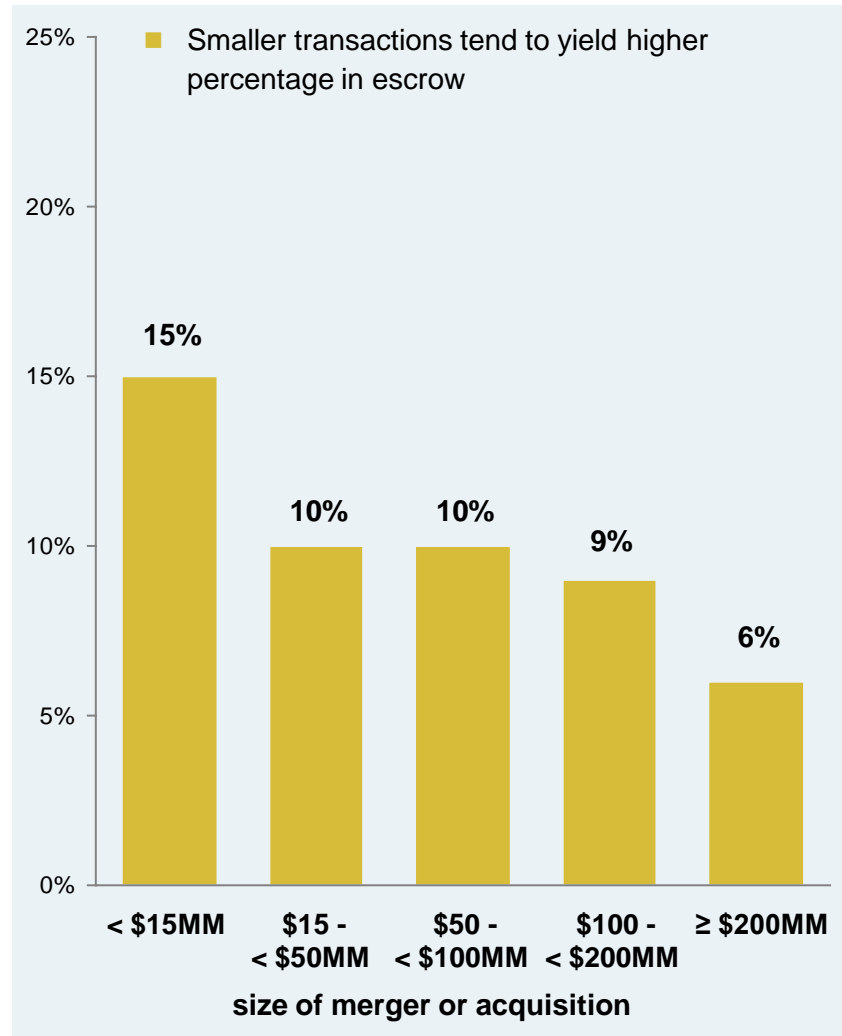
<sup>1</sup> Value of cash escrow deposits only; stock escrow deposits excluded

# Purchase price placed in escrow

Distribution of the percentage of purchase price placed in escrow<sup>1</sup>



Average percentage of purchase price placed in escrow by merger or acquisition size<sup>1</sup>

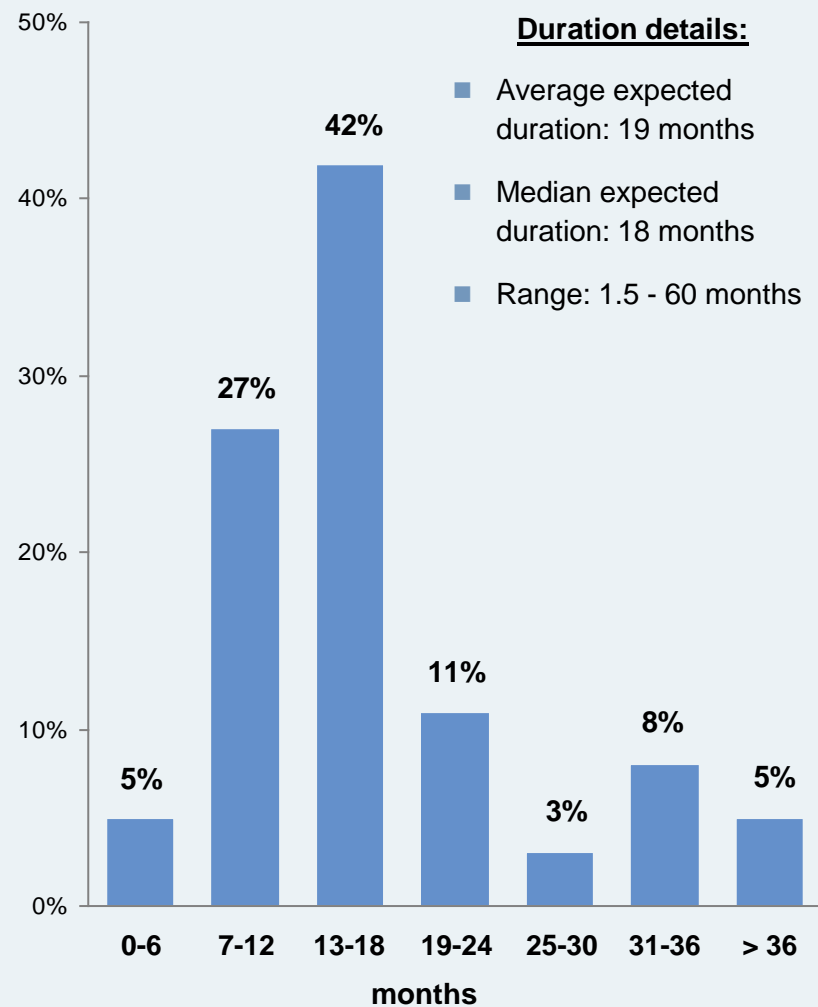


<sup>1</sup> Value of cash escrow deposits only; stock escrow deposits excluded



# Escrow lifespan

## Expected duration of escrows<sup>1</sup>



## Duration deep dive

- 76% of escrow agreements specify a termination date
  - 18 months is the most prevalent termination date
  - 12 and 24 months are the next most common
- Escrows often terminate early due to client instructions
  - 24% of terminated deals did so more than 1 month before their scheduled termination date

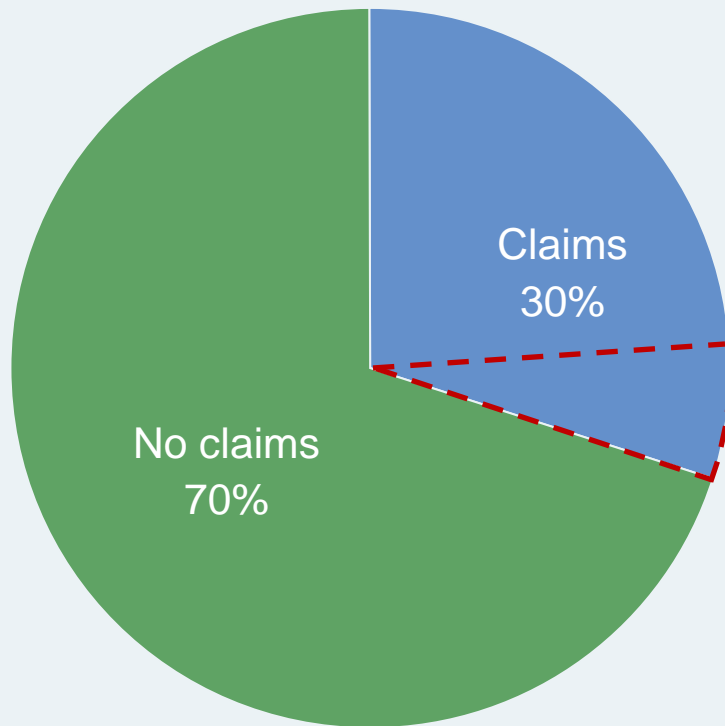
## Scheduled disbursements

- 29% of escrow agreements include at least one scheduled disbursement to the seller prior to the final disbursement
  - Timing: Of those with scheduled disbursements and specified termination dates, 53% require a disbursement at one-third or one-half of the expected duration
  - Amount: 42% of first scheduled disbursements require exactly half of the funds to be returned
- Deals with scheduled disbursements are prone to longer durations
  - Average expected duration: 25 months

<sup>1</sup> Expected duration is defined as the number of months that funds are scheduled to stay in an escrow account prior to the final disbursement to the seller, as explicitly stated in the escrow agreement

# Claims overview

## Percentage of terminated deals with a claim



6% of deals had more than one claim

## Claims explained

### Definition

- Disbursements to the buyer that are not delineated in the escrow agreement<sup>1</sup>

### Claims process

- 79% of escrow agreements have an explicit clause dedicated to the claims process
  - A timeline is established for buyer to make a claim, seller to object and escrow agent to disburse funds
- 54% of claims were filed within one month prior to termination

### Forms of claims presentation to escrow agent

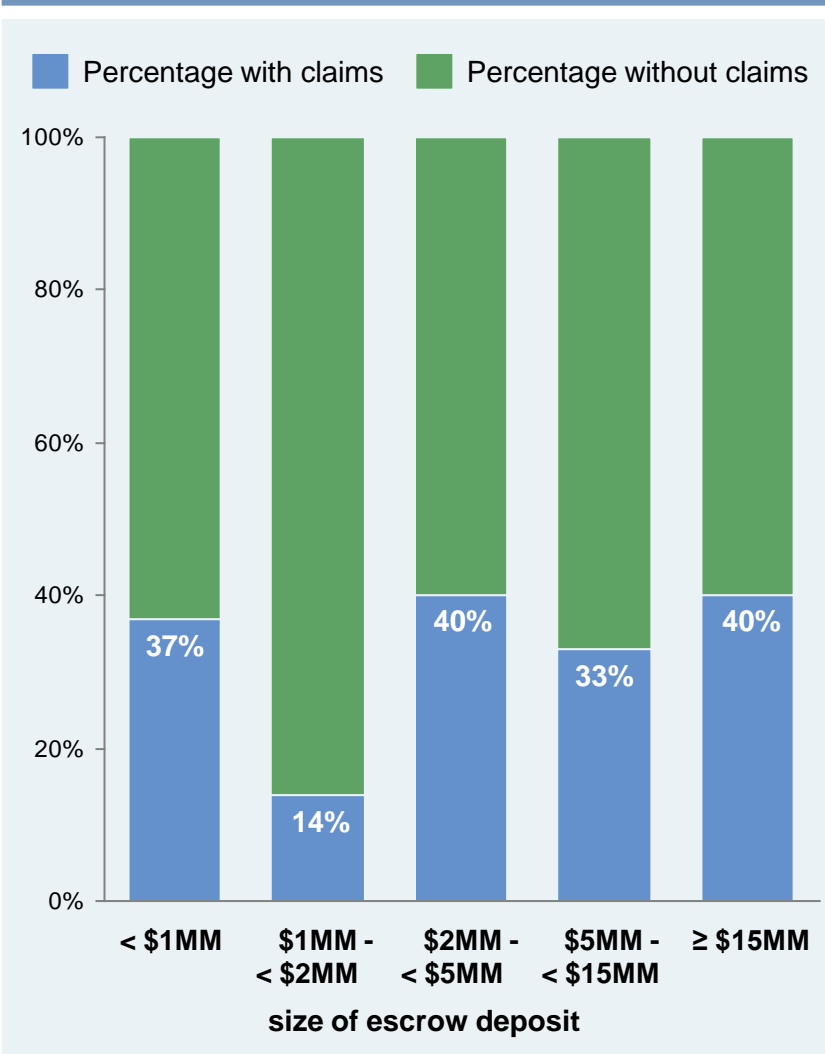
- Claim notice (18% of all claims were in this form)<sup>2</sup>
  - Letter filed by buyer with the escrow agent that certifies an indemnification claim and requests disbursement of funds
  - Seller can file a counterclaim if disputed
- Court order (2%)<sup>2</sup>
- Joint written notice (80%)<sup>2</sup>
  - Assumes that buyer and seller bypass the typical claims procedure by negotiating on a settlement price prior to engaging the escrow agent

<sup>1</sup> Excludes interest payments and income tax disbursements to the buyer

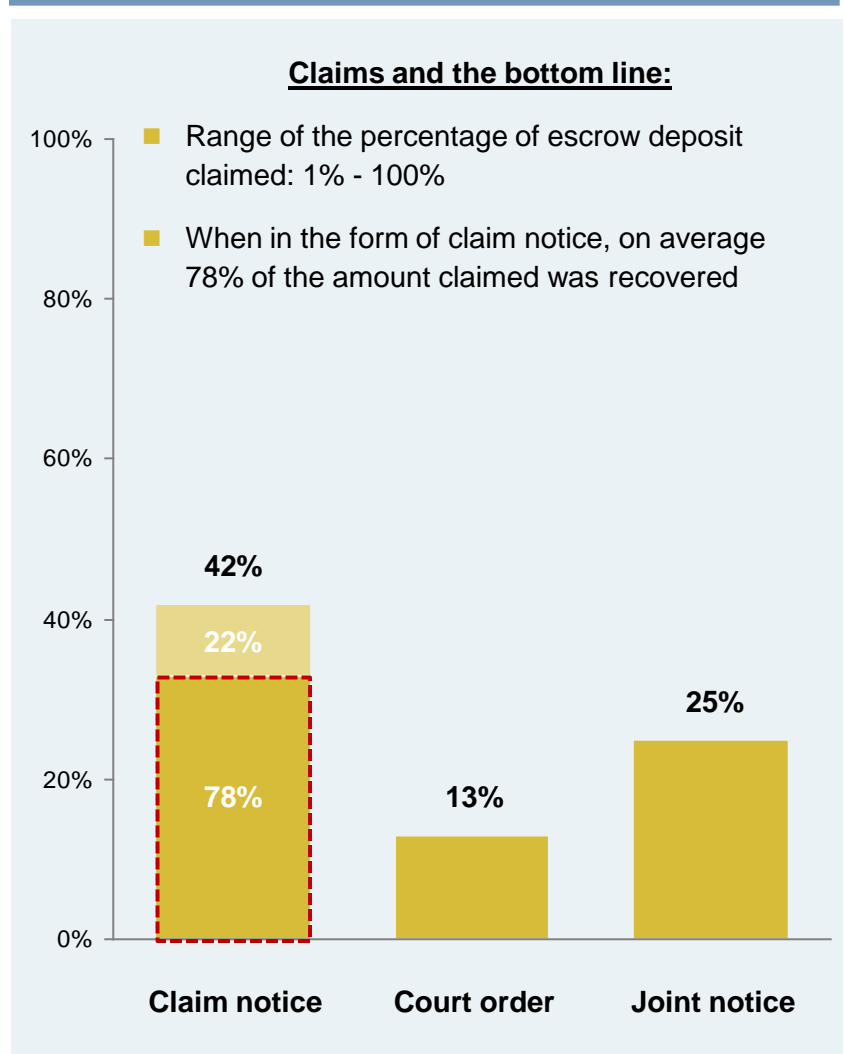
<sup>2</sup> Claims from both terminated and active deals included

# Claims overview (con't)

Percentage of deals with a claim by escrow deposit size<sup>1</sup>



Percentage of escrow deposit claimed<sup>2</sup>

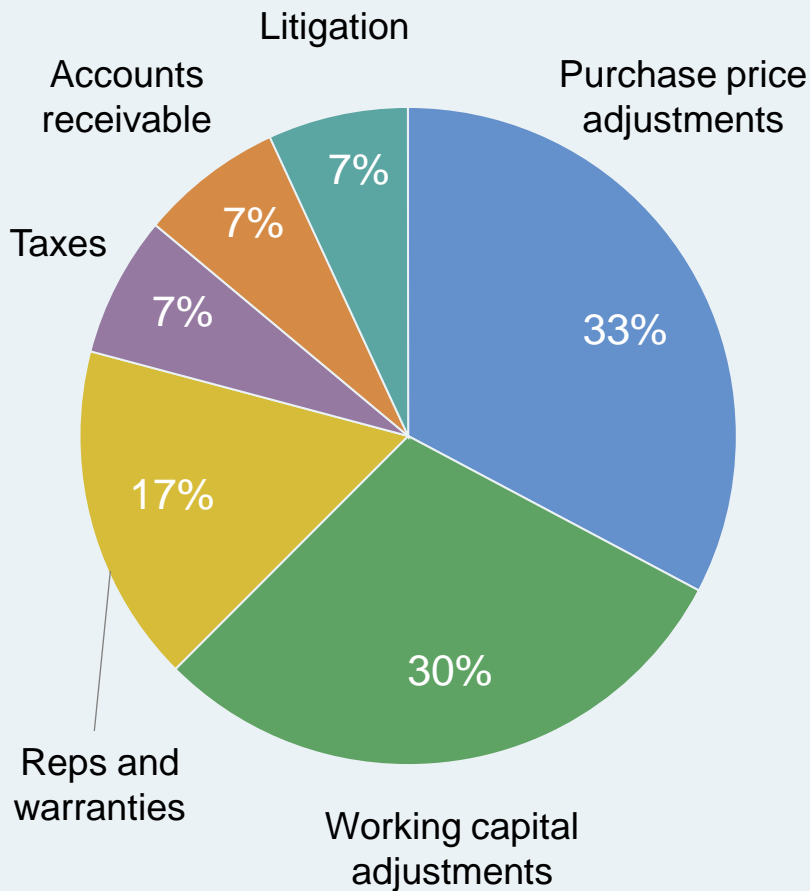


<sup>1</sup> Terminated deals only. Value of cash escrow deposits only; stock escrow deposits excluded

<sup>2</sup> Active and terminated deals

## Claims overview (con't)

### Claims reasons<sup>1</sup>



### Real-world examples

#### Representations and warranties claim

- Purchase agreement signed in Q3 '08 for \$3MM in cash
- Escrow agreement closed on the same day; \$600,000 total deposit
  - Two accounts: Representations/Warranties (\$500,000) and Purchase Price Adjustment (\$100,000)
- Jointly written disbursement instructions filed with Escrow Agent 12 months later (two days prior to expected termination date)
  - Escrow Agent to disburse entire \$500,000 from the Representations/Warranties account to the buyer
- Account terminated upon disbursement of funds

#### Taxes claim

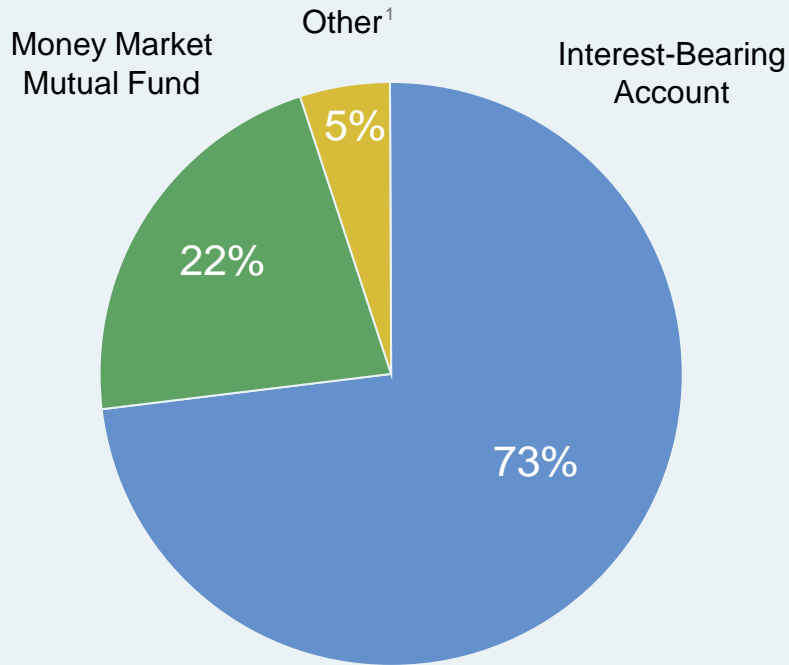
- Purchase agreement signed in Q1 '09 for \$26MM
- Escrow agreement closed on the same day
  - \$2MM deposit with estimated duration of 15 months
  - General indemnification account
- Buyer filed claim in Q1 '10 for over \$130,000, citing tax matters as reason for claim
  - Seller did not file an objection notice within 20-day allocated objection period
  - Entire amount claimed was disbursed to the buyer after expiration of 20 days<sup>2</sup>

<sup>1</sup> Active and terminated deals; reasons based on J.P. Morgan Escrow Services' filings and conversations with clients; excludes claims for which a reason was not ascertained

<sup>2</sup> Deal still active at time of study

# Escrow investment options and fee payments

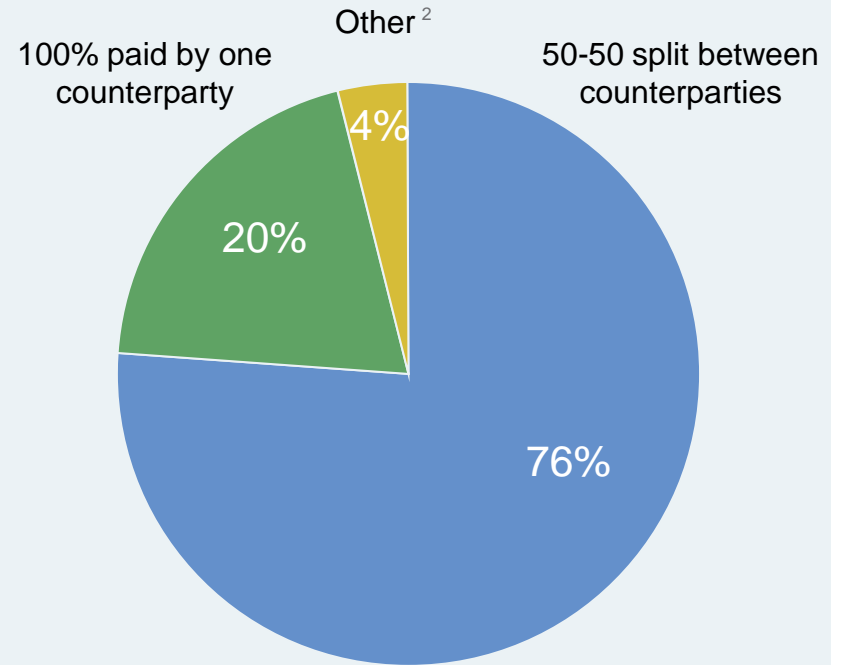
## Investment of cash deposits



### Popularity of Interest-Bearing Accounts

- Over 70% of cash deposits were invested in Interest-Bearing Accounts

## Escrow fee payments



### Significance of a split-fee arrangement

- 80% of the time fees were split between counterparties
- Indicates that both buyer and seller value holdback escrows

<sup>1</sup> "Other" consists primarily of non-interest bearing accounts

<sup>2</sup> "Other" denotes different fee structure, the most popular of which is a 75-25 split between counterparties

# Appendix

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# Heard in the marketplace: Discourse on the value proposition of holdback escrows

## Benefits to seller<sup>1</sup>

### Increases valuation of private targets

- Holdback escrows help to overcome asymmetric information in the markets

### Limits joint and several liability

- When there are multiple shareholders of the Selling company, escrows provide for Seller security by clearly outlining liability and claims processes in the escrow agreement

### Provides a form of reverse insurance in the form of “caps”

- Seller liability is often limited in amount to the value of the escrow deposit earmarked for damages (i.e. “cap”) and also in time by the life of the escrow

### Reduces immediate tax burden

- The contingent portion of the purchase price (the escrow amount) may be tax deferred, thereby reducing the seller’s immediate tax burden

### Ensures payment of earnouts via offset provisions

- Among deals with earnouts and determinable offset provisions, approximately 85% were found to allow for the right of set-off<sup>2</sup>
- This provides security to the seller against non-payment by the buyer

## Benefits to buyer

### Protects the buyer against false representations and warranties and / or the dishonoring of covenants by the seller

- Achieved through indemnification provisions
- Among transactions in which representations and warranties survived closing, 83% were supported by a holdback escrow as it mitigates buyer risk<sup>3</sup>

### Mitigates volatility risk

- Purchase price adjustments protect the buyer against economic downturns
  - Holdback escrows capture changes in value—which are most prevalent in uncertain economic times—that occur between the negotiation stage and closing

### Minimizes the risk of post-closing target devaluation

- Holdback escrows often support the retention of key employees who are pivotal to the future success of the business

### Ensures that the seller pays its agreed-upon share of advisers’ fees

- Protects the buyer against non-payment by the seller
- This concern is most relevant when purchasing distressed assets

<sup>1</sup> Dr. Lubomir P. Litov, Asst. Professor of Finance, John M. Olin School of Business Washington University in St. Louis, May 2010

<sup>2</sup> American Bar Association (ABA). (2009). 2009 Private Target M&A Deal Points Study [White Paper]

<sup>3</sup> Houlihan Lokey. (2010). Q1 2010 M&A & Financing Market Overview [White Paper]

## Why J.P. Morgan Escrow Services?

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### **E**scrow experts

A dedicated global team that delivers flexible solutions for a wide range of transactions

### **S**olutions model

Escrow solutions integrated with investment options, foreign exchange services, payment services and online reporting

### **C**ross-border capabilities

With Escrow offices on every continent and on-the-ground experts to guide clients through local laws and regulations

### **R**esponsiveness

From a client service team that stays with the transaction from start to finish.

### **O**utstanding coverage

Full range of document templates – by agreement type and by specific governing laws – that speed transaction closings

### **W**orks fast

Contracts are reviewed within 48 hours by a dedicated team of document specialists



## J.P. Morgan is a leader in the global Escrow market

The most qualified global escrow services provider with:

- \$30 billion under management
- 5,000+ actively managed accounts
- 1,400 new accounts annually
- 185+ Fortune 500 clients
- 100+ experienced professionals
- 100+ years experience in the U.S.
- Global capabilities
  - Escrow Servicing Centers on every major continent
  - Transactions possible in all major currencies
- Dozens of Escrow legal templates
- Fast turnaround



## Questions / contact

**Please visit our website at:**

*[www.jpmorgan.com/escrow](http://www.jpmorgan.com/escrow)*