

# Small M&A deals see drop in size of termination fees

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Amid a strong seller's market in mergers and acquisitions, the size of termination fees in deals involving small companies has plummeted, suggesting that smaller players have gained bargaining power in recent quarters.

Over the past six quarters, the average size of termination fees in deals of less than \$25 million has dropped from 7.64 percent to 4.26 percent, according to analysis conducted by **Curtis Financial Group**, a Philadelphia-based investment banking firm.

A target company pays a termination fee, also known as a breakup fee, if it reneges on a promise to sell itself to a buyer.

Buyers may insist on a termination fee for any number of reasons. Termination fees act as insurance against the target company abandoning the deal for a better offer, or may reimburse a buyer for costly due diligence if the target turns out to be less than expected. Though less common, targets may also insist on termination fees from buyers.

**Curtis Financial** Vice President **Howard Snyder** studied mergers and acquisitions with termination fees in their terms of agreement tracked by Capital IQ, a private subscription database service, that were announced between January 21, 2005, and June 30, 2006.

He cautioned that the study covered a relatively short period of time, however, the drop of more than 3 percentage points, or 44 percent, indicates sellers are retaining more leverage in dealing with buyers.

"Although there is no corroborating data, we would attribute the reduction to the continued strong merger-and-acquisition market, which may have allowed targets to negotiate better terms such as lower breakup fees," **Snyder** said.

**Snyder** also hypothesized that board directors might play a role in the trend toward lower fees, by being more sensitive toward fulfilling their fiduciary duty to shareholders. "This responsibility might include taking a more aggressive response to negotiating a lower breakup fee to reduce the potential cost to the company," he said.

A lower termination fee is desirable for acquisition targets because it reduces their potential liability in a broken deal. In cases where a termination fee exists, the company is obligated to pay the cost 75 percent of the time, **Snyder** said, based on the data analyzed.

The data showed that termination fee percentages remained consistent for transactions with enterprise values of all other sizes, indicating that small transactions have become more competitive with the rest of the market.

"The larger deals are already relatively competitive, so the efficient market theory applies," **Snyder** said.

Average termination fees in transactions of \$50 million or more were 3.2 percent in a 2004 study by international investment banking services company Houlihan Lokey Howard & Zukin.

James Still, managing director and head of investment banking at Boenning & Scattergood, a securities firm in West Conshohocken, said the strength of the mergers-and-acquisitions market is "clearly the driving factor in driving breakup fees downward."

In the first quarter of this year alone, companies in the Philadelphia region were buyers or sellers in 140 deals valued at \$94.1 million, compared with 119 deals valued at \$70.1 million in the same period the year before, according to data from **Curtis Financial Group**.

Still said small companies have found more opportunity in mergers and acquisitions lately than in previous years because many private-equity funds are going "down market due to competition at the higher-valued companies level."

"In addition, because many of the [private-equity] firms are looking for bolt-on acquisitions for their portfolio companies -- this increases the appetite for smaller companies," he said.

In other words, smaller companies have more of an advantage in current breakup fee negotiations because of the high levels of capital searching for a good investment to call home.

"The presence of highly liquid financial buyers and cash-rich strategic buyers continues to drive a healthy market for sellers of companies," Still said.

Although increasing emergence of activist shareholders and activist hedge funds could have factored in the reduced size of termination fees, Still cautioned that it might be too early to gauge the impact of hedge funds in the mergers-and-acquisitions market.

"Down the road, if the hedge funds do, in fact, start to play an increasing role in the M&A market, then clearly that impact will be to increase the competition for companies seeking to sell," Still said.

A more competitive market translates into smaller companies gaining more bargaining power during deal negotiations, which include negotiations over termination fees.

"While the increase in interest rates has impacted the M&A market, the strength of the private-equity community and the high level of cash on the books of corporate America continue to drive a very healthy domestic and international M&A climate," Still said. "So this breakup fee trend will continue to parallel the strength of the M&A market, which is not showing any signs of tempering."