Private Equity M&A

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Private Equity Firm and Fund – Simplified Structure Chart

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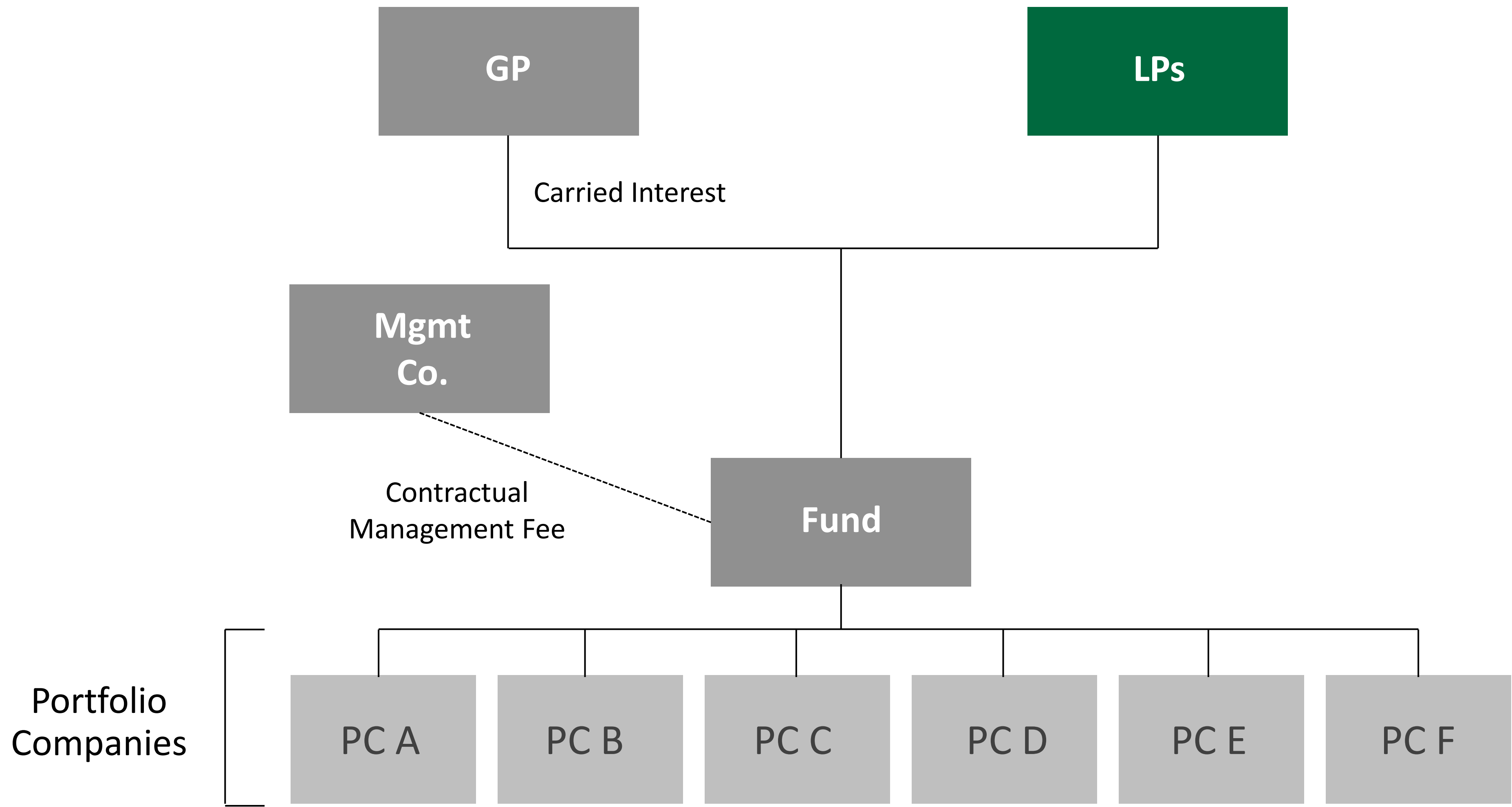

The Simple is no longer Simple

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- Tax sensitive investor (international) now requires separate feeders to mitigate FIRPTA/ECI, etc.
- LP leverage has led to a proliferation of specially managed accounts (SMAs), Funds of Funds, etc.
- The Private equity industry is now mature and years of negotiation have led to a cottage industry in Side-letters requests
- Fundraising demands have caused sponsors to seek alternative (Longer Life) capital solutions, Permanent Capital Vehicles, SPACs, Foreign Listed Funds
- Investors want to co-invest alongside funds to average down their fees and build industry expertise – Mostly the larger sovereign wealth funds – creates complexity

Private Equity: Sponsor and the Fund

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- **Private Equity – what is it?**
  - Historically, long term investors predominantly in the equity of private companies
    - As the size of PE Funds has grown, PE acquisitions of publicly traded companies have increased
    - Can invest across range of sectors, geographies or stages – our fund is energy focused but many are generalist
    - Competition and market distress now have PE investing across the capital structure
- **Private Equity Structure**
  - Raise limited life funds from primarily institutional investors (pension funds, sovereign wealth funds, family offices)
  - Investors make capital commitments to the funds, funds are called over time
  - The PE firm receives
    - An annual management fee of 1.5-2% of capital commitments from the funds it manages, stepping down to a lower amount after the commitment period
    - 20% of any profits over a preferred return (typically 8% but some funds have less) generated by the investments it makes (can be lower if lower risk/lower reward strategy)

Private Equity: Sponsor and the Fund

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- **Distinction between the "sponsor" or "firm" and the "fund"**
  - Sponsor / Firm = Management Company
    - Ongoing entity
    - Employer of individual PE professionals
    - Manager of PE funds
    - Not an "investing entity"
  - Fund
    - Often structured as a limited partnership
    - Investing entity that raises capital from investors, typically limited partners in a limited partnership often called “LPs”
    - Make several distinct and segregated investments, often referred to as “portfolio companies"
    - Typically has a limited life (10-12 years), including fixed investment period (4-7 years) followed by harvesting period when investments are sold
    - Size of asset base varies over fund’s life

The Private Equity Acquisition

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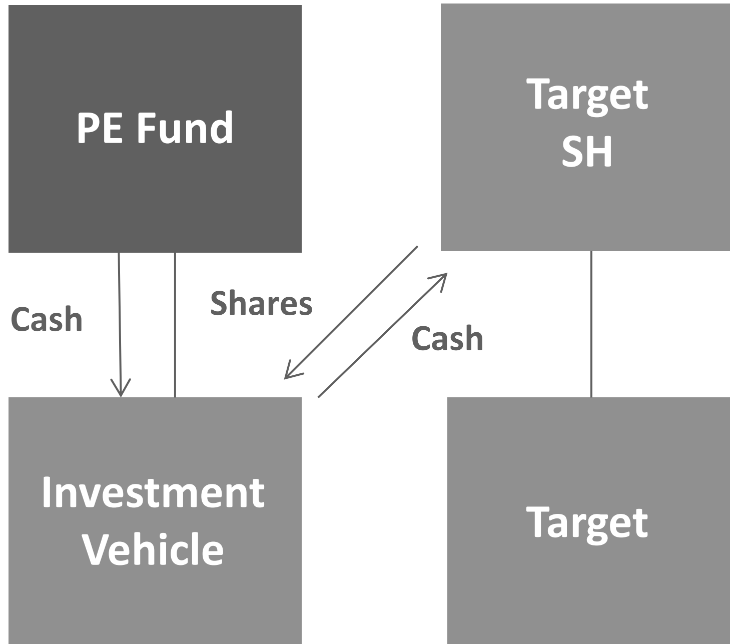
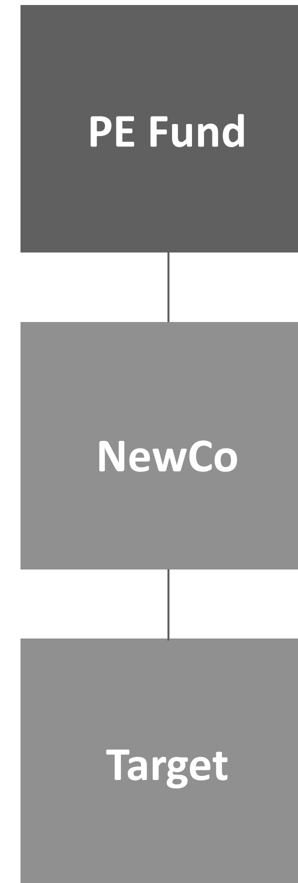
The Transaction



Sources		Uses	
Debt	$80,000,000	Repay Existing Debt	$25,000,000
Equity	$20,000,000	Equity	$74,000,000
		Expenses	$1,000,000
Total	*$100,000,000*	*Total*	*$100,000,000*

Post-Transaction Structure



The Private Equity Acquisition

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- **Private Equity Transactions involve negotiations with:**
  - Sellers (purchase agreement)
  - Lenders (debt commitment papers) – PE investments are segregated and not cross-collateralized so separate debt packages are negotiated in each case
  - Management (equity incentive plans, employment agreements, shareholders agreement, registration rights agreement)
  - Co-investors (shareholders agreement, registration rights agreement)
- **Management of the Target are often on both sides of the transaction**
  - Makes for interesting negotiations with your future employees
  - Raises questions of conflicts and may require separate negotiators
- **There are often multiple layers of debt (term debt, bonds, revolving credit facility, mezzanine financing)**

What makes Private Equity M&A Different

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1. Exit is King- We start thinking about the exit before we buy the company

2. The Fund has no balance sheet - Debt financing requires active cooperation and participation of the Target, it is the Target's balance sheet that is being used to support the debt, not the fund

- Financing assistance covenants are long and heavily negotiated, may be hard to have a level of specificity that completely satisfies selling shareholders
- Target management time and attention will be required to finalize debt financing
- Impact of Target's failure to meet its obligations under financing assistance covenant is a topic of negotiation
- To some extent always reliant on PE Sponsor's relationship with debt financing sources

3. Private Equity buyers have different anti-trust concerns than strategic buyers

- PE Funds have greater flexibility than a strategic buyer
- PE Funds (or PE sponsors) may have overlapping but unrelated portfolio companies that cause additional review

Continued

4. **PE Funds are limited life entities**

- Certainty of scope of sellers' indemnification exposure is valued – Rep and Warranty Insurance
- Fraudulent Conveyance Insurance
- They want to avoid having to go back to their investors for capital if there is an indemnification claim and have a limited ability to do so

5. **PE Funds are rarely 100% owners**

- Minority shareholders likely to include management, possibly other significant investors – “skin in the game”
- May make discussions about credit support in respect of indemnification obligations related to a sale more complex
- Frequent use of escrows of limited life

The Private Equity Acquisition – How to Solve for No Balance Sheet

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Goal	Protection in Documentation
PE Fund's Maximum Exposure Limited to Equity to be Invested if Deal Closes.	Newly formed entity ("NewCo") signs Purchase Agreement, PE Fund's exposure limited to equity commitment letter that can only be drawn in specific circumstances.
Limit potential damages to PE Fund if debt financing sources fail to fund through no fault of PE Fund.	Usually damages are limited to fixed "reverse" breakup fee payable by NewCo and backed by Guarantee from PE Fund if lenders fail to fund.
Damages payable by PE Fund in the event of breach of purchase agreement by NewCo and termination by Target should be limited.	NewCo damages in the event of a breach of purchase agreement limited to "reverse" breakup fee amount.
Eliminate Instances where Debt can legally elect not to fund but PE Fund will be forced to fund Equity.	Match debt commitment letter and purchase agreement drop dead dates. Match (as closely as possible) closing conditions in debt commitment letter and purchase agreement.

A Partial Solution? - Special Purpose Acquisition Company “SPAC”

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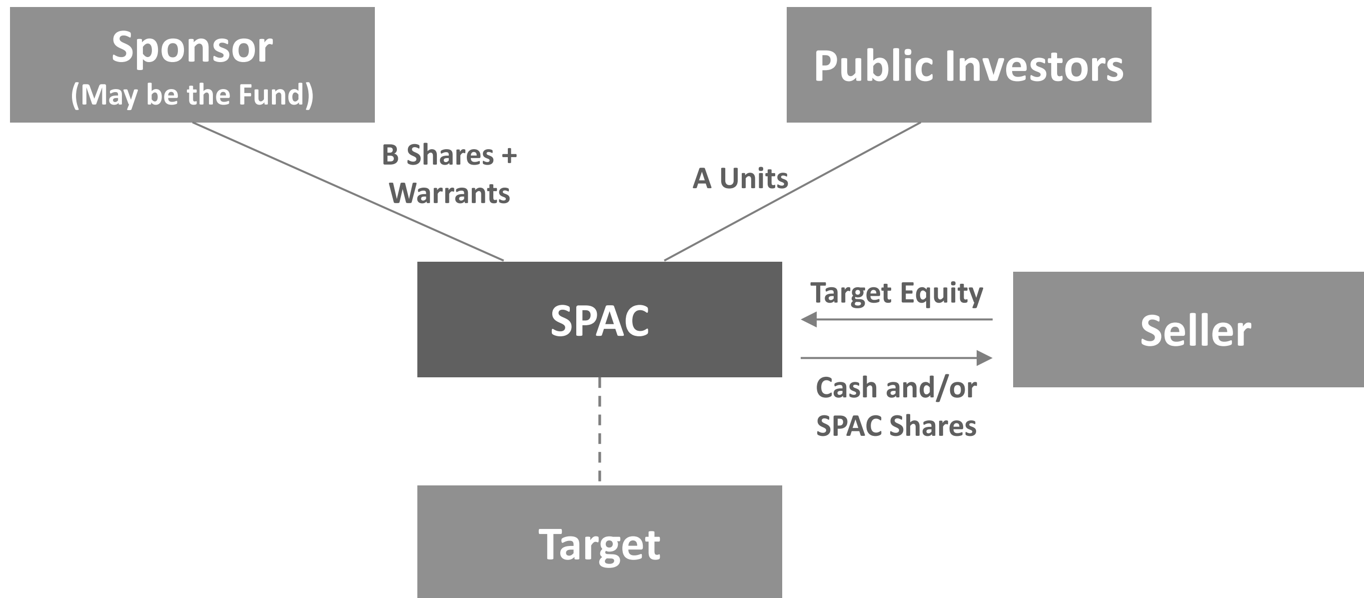
Special purpose acquisition companies (SPAC) are publicly-traded buyout companies that raise collective investment funds in the form of blind pool money, through an initial public offering (IPO), for the purpose of completing an acquisition of an existing private company, sometimes in a specified target industry such as information technology. The money raised through the IPO of an SPAC is put into a trust where it is held until the SPAC identifies a merger or acquisition opportunity to pursue with the invested funds. Shares of an SPAC are typically sold in relatively inexpensive units that include one share of common stock and a warrant conveying the right to purchase additional shares or partial shares.



A Partial Solution? - Special Purpose Acquisition Company “SPAC”

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- **Sponsor of the SPAC raises capital in the public market and puts the cash in a trust pending the closing of an unspecified deal**
- **Sponsor usually take a promote of 20% of the Company upon acquisition of a target – straight interest - no preferred return**
- **Sponsor cannot have a deal to put in the SPAC at the time of the IPO – must be unspecified**
- **SPAC must use at least 80% of the cash in the trust for a single deal within 24 months or give the money back to investors**
- **Public market investors buy “units” comprised of one share and ½ or ⅓ of a warrant to purchase a share**
- **SPAC cannot on its own pay a deposit which makes a deal difficult to secure**
- **Any deal requires the vote of a majority of the SPAC investors and SPAC investors may redeem their shares at the time of the DE-SPAC – Means the deal must be strong enough to support dilution from the sponsor promote**
- **A fund alongside a SPAC or as the sponsor of a SPAC can solve the deposit issue and provide huge benefits to the fund:**
    - A possible mitigant to the lack of a balance sheet
    - Gives a fund cash as well as public shares to use for consideration
    - Gives an acquired company immediate access to the capital markets to grow

Limited Specific Performance
Key Features

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- **Limited specific performance is utilized in buyouts involving both debt and equity financing**
  - At signing:
    - Sponsor fund delivers commitment letter to shell Buyer entity
    - Debt financing sources deliver debt commitment letter to shell Buyer entity
  - Provides target may specifically enforce equity commitments **only if**:
    - All other closing conditions are satisfied and Target certifies as such
    - Debt financing is funded substantially concurrently
  - Target may be named a third-party beneficiary to equity commitment letters or have the right to force shell Buyer entity to enforce the equity commitment letter
  - Buyer may or may not have the obligation to initiate litigation against financing sources to enforce debt commitments
  - Remedies upon a financing failure may be limited to a reverse termination fee, but supported by a limited guarantee from the sponsor

Alternatives to "Limited" Specific Performance

Pure Option, Financing Condition and Full Specific Performance

- Alternative approaches to the "limited" specific performance construct may be utilized if PE bidder feels it is in a situation with an exceptionally small/large amount of leverage, or due to practical considerations with respect to transaction size
- **Pure Option (or No Specific Performance)**
  - In the event a Buyer does not close a transaction, the Target has:
    - No ability to specifically enforce equity commitments
    - Remedies against judgment proof shell Buyer generally worthless
    - May have specified limited remedy in the form of reverse termination fee supported by a limited guarantee from sponsor
- **Full Specific Performance**
  - The private equity sponsor commits to fund the full purchase price
  - Target may specifically enforce equity commitments, regardless of whether or not debt financing is in place
  - Most often used in very competitive bid scenarios with smaller Target companies
- **Financing Condition**
  - Buyer has no obligation to close if financing is not available on specified terms
  - No remedy against Buyer if the financing condition is not satisfied

Reverse Termination Fees
Size and Structure

- In a “limited specific performance” or “pure option” conditionality construct, a reverse termination fee usually serves as the sole remedy to the Target for a Buyer’s failure to close
  - If Target is appropriately advised, the reverse termination fee will be guaranteed by the private equity sponsor (as Buyer entity is judgment proof)
- Size of reverse termination fee may vary significantly depending on competitive aspects of buyout process
  - In public target transactions, where the Target is obligated to pay a termination fee in certain circumstances, the reverse termination fee is typically 2x the termination fee
  - In private target transactions, reverse termination fees have tended to be larger as a percentage of equity value (perhaps due to relatively smaller deal size or more consolidated negotiating power by Target)
    - While less survey data is available for private transactions, market norm is considered closer to 5% of enterprise value

Exit Flexibility

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- There are a variety of exit options for sponsors, including:
  - A sale of the business (stock or asset)
    - Immediate liquidity
    - Value certainty
  - An initial public offering
    - Partial liquidity event
    - Potential future liquidity in staged exit
    - Potential market value arbitrage
  - A merger

  <u>Relative initial valuation may be impacted by:</u>
    - Strength of capital markets
    - Prospective buyer's cost of capital
    - Synergies
    - Future growth prospects that are valued by buyers but not by IPO market
- A "dual-track" process involves the simultaneous pursuit of both an initial public offering and a negotiated sale generally through a controlled auction process

Potential Benefits of Running a Dual-Track Process?

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- Potential to obtain best achievable value
  - Provides multiple sell-side options
  - Maximized competitive tension
  - May provide price guidance
- Provides negotiating leverage on deal terms
- Provides flexibility and less dependence on strength of M&A or IPO market
- Imposes a disciplined timetable on buyers
- IPO process may result in additional information for bidders
  - Potentially higher valuation
  - Expands scope of potential bidders

KEY FACT: A recent 10 year study found that sales following a dual-track process resulted in an average 22-26% higher premium than a single-track sale.

Potential Disadvantages of Running a Dual-Track Process

- Requires significant management time and attention
  - Limit time and attention to customers, business and strategy
- Competing priorities may lead to sub-optimal results
- Conflicts between management and private equity owners may result
  - Appropriate compensation programs are important
- IPO process may require disclosures of competitively sensitive information
- Higher up front costs
- Need to take care to avoid potential legal issues
  - Gun jumping issues associated with IPO
  - Bidder standstills for post IPO periods

JOBS Act Provides Additional Flexibility

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- JOBS Act has made running tandem processes much easier for "emerging growth companies" (less than $1 billion in revenues)
  - Lessened financial statement requirements
    - 2 vs. 3 years of audited financial statements
- Permits confidential review of registration statement up until 21 days prior to the roadshow
  - Registration statements may be pulled free of stigma
  - Sellers may time first public filing to increase leverage in M&A negotiations
- Permits additional "test the waters" communications to gather information about potential IPO valuation
- Reduces costs of going public through phased in regulatory requirements

Dual-Track Process Overview

- Approach targeted list of logical strategic and financial buyers
- Simultaneously prepare an S-1 for an IPO
- Actively pursue both paths on an accelerated timetable
- Clearly communicate nature and timing of dual-track process to potential buyers
- Interested buyers are forced to move quickly or risk target becoming public
- Dual-track decision point occurs generally after clearance from the SEC (or for emerging growth companies, potentially when decision is made to publicly file S-1) and receipt of final bids from buyers
- Estimated timing: approximately 4-6 months from start to closing