INSIDE THE MINDS

Understanding Legal Trends in the Private Equity and Venture Capital Market

Leading Lawyers on Navigating the Current Economy, Managing Risks, and Understanding Changing SEC Regulations

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Private Equity: The Path to Efficiency

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Introduction

Sell-side auction processes and focus on the debt financing—this is the current state of play. Auctions, where a target is put up for sale through an auction process with a sell-side investment bank, are now commonplace for companies with an enterprise value greater than $50 million. This of course introduces a classic competitive dynamic in a blind bidding process (e.g., they only know their own bid value). Now that we are several years past the financial crisis environment of 2008 to 2010, the fact that sellers are both conscious of and no longer want to take the risk that a buyer cannot close due to a financing failure is also commonplace.

And the Company Goes to…

Here, the familiar adage, "There are no points for second place," is both true and painful. Typically, when a private equity firm purchases a company, it acquires it with a combination of equity and debt. And in some cases, a deal may require more equity than a particular private equity firm can speak for in any particular transaction due to certain fund limitations in the fund's own limited partnership agreement (e.g., they are limited to a certain amount of equity commitment per deal to ensure diversity in its investments). This may require co-investment arrangements with additional sources of equity capital, often with the private equity fund's existing limited partners. But even if the fund can write the entire equity check, a material portion of the total sources will still be funded through debt in a typical buyout. Hence, there is nearly always inherent uncertainty when it comes to the money. There are exceptions of mega- and large-cap private equity firms speaking for the entire financing package, but this often occurs when a large market player dips down into a lower tier of the market.

So while sellers increasingly are pushing this risk to the buyer, many private equity sponsors are unwilling to take this risk completely, and expose their fund to serious negative consequences, creating the need for a compromise position. The birth of the reverse termination fee and its counterpart the limited guarantee has helped bridge this issue, to a degree. Essentially, if the financing for the deal did not come through, the private equity sponsor pays a defined fee to the seller, and in turn the private equity firm has limited its exposure significantly. But this illusion of beauty has an ugliness within. Sellers do not want to receive a reverse termination fee—they want to close the deal. Private equity firms do not want to spend several million dollars to *not* close a deal either. But we walk across this bridge anyway, hoping we all make it to the other side. And for the most part, it has been holding up, so long as we do not look down. A solution, but an imperfect one.

Indeed, the financing commitment letters go a long way toward making sure this bridge does not break. But the timing of such letters, or rather the moment at which the due diligence out is removed and they are fully executed by the lenders, has created a shift in the deal dynamics. While private equity firms and banks have been putting commitment letters on the table for years, they would often turn up right before a deal was signed (literally, right before), which of course would be after a bidder was selected in an auction and the parties had been negotiating under exclusivity for some length of time. Now these letters (with the diligence out removed) are being required by sellers at the final bid stage *before* a purchaser has been selected to negotiate exclusively. This gives both the seller and the buyer more assurance that the debt financing will be available at closing, but creates the need for the private equity firm and its lender to complete the process up to that point while the bidder has no assurance that it will win the auction. Banks now have to perform all diligence matters as a part of a bid package, as opposed to backing a buyer negotiating exclusively with the seller. This implies of course that the private equity firm has completed its business, legal, accounting, tax, and other diligence, as it must be well in front of their financing sources.

This need to finalize due diligence is leading private equity firms to incur significantly higher costs than before, as they need to work with various advisors to complete diligence and then get each potential lender through that diligence. It was not atypical for a legal due diligence report to be prepared concurrently with exclusive negotiations, which comes with material time and cost. Now this must take place before a private equity firm can even render a final conforming bid.

Does this weed out bidders that are not serious? Does this give an advantage to the well-funded? Does this discourage would-be bidders that are not willing to incur these increased costs up front? Does it create the need for a lot more people to do a lot more work up front that will not likely result in a deal for most of them? Yes. Is that efficient?

Got Management?

Sellers want to know what the deal will be for management (and so does management), and neither party wants to create any management hold up value. This in turn creates the need to outline, negotiate, and, with increased frequency, finalize all management documentation, at the bidding stage, to erase any uncertainty regarding management. This was customary in approach by the signing phase, and in many cases was yet left for the executory period (e.g., after signing but on or before closing), perhaps based on a term sheet outlining the material terms of the management deal. Pushing this aspect up to the final bid stage introduces yet another set of third parties that must act, and this is a very special set of actors indeed, as they are either already running the business or will be at closing. These arrangements can vary in complexity but can be quite complex and require significant documentation, from employment agreements to equity and profit interest arrangements. This in turn adds more to the to-do list prior to submitting a bid without assurance of a deal for the bidder.

The Unwanted Markup

A question we used to ask with regularity: do we have to mark up the purchase agreement? Sellers began to require this to submit a conforming bid. This used to represent one of the more material time and cost centers involved in a bid submission, especially if most of the legal diligence would be performed once the bidder was selected. Sometimes comment memoranda were submitted in its place, without significant negative reactions to warrant marking up the entire purchase agreement. But in recent years, as the increased front-loading has taken place to the bid stage, the time and costs of getting through full diligence and then getting the lenders through it as well, among other items, the cost of the full markup seemed in relative terms to be more minor on balance. As such, it may pay to play by the rules and submit a conforming bid.

But at the same time, sellers started to negotiate with multiple bidders with increased frequency to a more final state of deal terms, which in itself requires not just a markup, but could require several rounds of negotiations and subsequent drafts of the purchase agreement. This may also require other advisors in addition to legal to be involved, such as accounting and other advisors. Again, before a bidder is selected.

More recently in fact, a detailed term sheet is being used in the first instance and there is no purchase agreement at the outset to mark up. However, marking up this term sheet, while in theory reducing time and expense, may just be an additional half-step if ultimately a full markup is then later required to complete the final bid stage. This remains to be seen, but this development could be promising, or yet another time and cost center prior to a final bid. (In the future, I envision a cloud-based interface with terms the bidders can select from in a base set of terms proposed by the seller in a toggle on or off fashion, but we are not there yet. Maybe in 2020.)

Footing the Bill for Certainty

The emotional distress one may undergo after completing all the deliverables necessary to submit a conforming bid (e.g., completion of all forms of diligence, reaching executed debt commitment letters with lenders without due diligence outs, final terms with management, a fully negotiated purchase agreement, representation and warranty insurance indications of terms, co-investor arrangements, investment committee approvals, etc.) that ultimately is met by a deafening silence by the sellers can be something to behold. For a few days, there is hope. Then a hopelessness begins to grow.

But for those who can spot the "green light" within the abyss and carry on: "It eluded us then, but that's no matter—tomorrow we will run faster, stretch out our arms farther…" Some will wonder why it is this difficult to spend a lot of money. It is true, it is. Such is the life of a private equity dealmaker and their key advisors.

But those who are not "borne back ceaselessly" will not only prevail but will also have done much of the work already by the time they sign. So there is a benefit for at least the prevailing purchaser. For those that lost, they are left facing professional fees and loss of opportunity costs. These costs can add up to several hundred thousand to several million.

This may squeeze out some market players who cannot afford this risk or do not wish to take it on as a pure business matter. This should leave only those who are very serious about the opportunity. But to some degree, there is an element of self-selection going on. And while bidders are being asked to minimize their own deal uncertainty, they are offered none in return from the seller.

This also puts additional pressures on other market participants in the bidding process, such as law firms, accounting firms, consulting firms, as well as others, as no one likes to pay fees for an opportunity lost. The need for strong partnerships and longstanding relationships between advisors and principals has never been more acute in this context. One can easily see how a smaller private equity firm or independent sponsor would have a more difficult time offering the kind of volume relationship one may need to achieve total alignment of these risks. The same trend is also having an effect on the banks that typically lend to the private equity firms. And here it can be somewhat exponential, as multiple lenders bid to back the bidder. In effect, a sub-auction is occurring at the debt financing level. And of course, a string of just plain old bad luck can cause great stress on these relationships.

Conclusion

Looking ahead, we are going to see increased movement from the customized to the packaged. Arguably, the private equity marketplace has already moved past the bespoke and is sitting in the standardized zone in its journey to a commoditized system of processes in a totally efficient market. Believe it or not, we are still in the early days. New products and technology, along with increased cost pressures, have sparked interesting attempts at achieving some of this.

Should this come to pass, it will alleviate the issues outlined here relating to the auction process and the increased costs and risks for bidders. It will reopen the private equity market to more participants. It could even become efficient without the cost overhang. The tools of today, such as a handcrafted markup of an auction draft, will one day resemble that of tools made from stone.

What will not be commoditized of course is whether one is making a good or bad investment. That is still entirely up to you.

Key Takeaways

- Sell-side auctions for companies are very common.
- Sellers are deeply focused on the financing failure risk.
- Sellers have asked bidders to do much more up-front work before a winning bidder is selected.
- Creating increased certainty for sellers has resulted in increased risk for individual bidders in terms of opportunity costs and expenses.

James L. Kelly, a partner at Winston & Strawn LLP, focuses his practice on representing private equity funds and other financial sponsors in all aspects of their investments, financings, and related exit transactions.

These transactions include primary and secondary leveraged buyouts, mergers and acquisitions, acquisitions of non-control equity interests, economic participations, co-investments and other investments and financings, as well as divestitures and restructurings.

Mr. Kelly also regularly represents public and private operating companies across a variety of industries, including the portfolio companies of his private equity fund and other financial sponsor clients, for which he handles a wide range of transactional and other corporate matters, including their strategic add-on acquisitions, divestitures, leveraged dividends, recapitalizations, restructurings and joint ventures.

He also represents investors and companies in a full range of venture capital financings, from angel to late-stage investments.

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