

## Driving The Deal - Private Equity

*Jeremy Clarke and Nigel Kotani (LLC Law) consider the position of private equity, which in their view remains an important sector for the banking industry and its advisors. The article explains the nature of private equity as well as looking at how private equity deals work in practice, both from a legal and financing point of view. They conclude the article by considering the evolving shape of private equity.*



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### Private equity in the current market

Before the crisis in the global economy took over the headlines private equity seemed to have become something of a buzzword. The early part of 2007 saw the announcement of seemingly ever-increasing deal sizes, with the acquisition of TXU, the Texas based energy provider, by KKR and Texas Pacific Group claiming the record as highest value deal with a price of US\$44 billion. That deal broke the previous record of US\$38.9 billion set only weeks earlier in February 2007, which in turn had broken the record of \$33 billion set in 2006. According to figures from the European Private Equity Venture Capital Association, a record €71 billion was invested in over 7,500 European companies in 2006.

Private equity's historic success began increasingly to be cast under a negative light, with questions first being raised about the social and economic impact of private equity's activities.<sup>1</sup> The private equity industry was seen as an opportunistic, asset-stripping, tax-dodging "swarm of locusts".

The industry began to launch something of a "charm-offensive"<sup>2</sup> in 2007 but the global banking crisis took over the focus of the headlines to such a degree that private equity has become something of a forgotten story.

As well as the large amount of capital raised by private equity firms, substantial use was generally made of leveraged finance by the industry, particularly in relation to the larger, headline-grabbing buy-outs.<sup>3</sup> There remains a substantial amount of money left available for investment by private equity firms but lack of availability of bank debt has meant that opportunities for investment are currently few and far between. This is ironic in a buyers' market.

Banks need to lend money in order to make money though, and although bank lending over the next couple of years may prove to be slower and more cautious than it was in the two years before the credit crunch, an increase in bank lending from current levels is inevitable. With that increase, some of

<sup>1</sup> House of Commons Treasury Committee, Private Equity, Tenth Report of Session 2006-2007, report together with formal minutes vol I published 30 July 2007.

<sup>2</sup> See, for example, Mike Wright, Michael Jensen, Douglas Cumming and Donald Seigal *The Impact of Private Equity: Setting the Record Straight*, CMBOR, 2007.

<sup>3</sup> Professor Mike Wright, Andrew Burrows, Rod Ball and Dr Louise Scholes *Private Equity and Buy-outs: Jobs, Leverage, Longevity and Sell-offs*, CMBOR (July 2007). According to the paper, the overall average combined share of financing accounted for by senior and mezzanine debt increased from 43.6 per cent in 2000 to 55.0 per cent in 2006, while for the very large deals total debt financing increased from 56.0 per cent to 69.6 per cent over the same period.

the money currently sitting in private equity funds will become available, and private equity is likely to remain a substantial source of funding for the foreseeable future.

### The Nature of Private Equity?

Before considering some of the legal issues arising in relation to private equity transactions, it is first necessary to understand what is meant by private equity. Private equity is a medium to long-term investment made in return for an equity stake in an unquoted company.<sup>4</sup> The term private equity, particularly as used in the media, refers to such investments when made by private equity funds, although similar activities may be undertaken by public companies, wealthy individuals (or their investment vehicles) and other sorts of funds, such as hedge funds and property and infrastructure funds. A characterising feature of private equity investment is the alignment of incentives between management and the private equity firm as owner by allowing management (often the founders in the case of venture capital funding) to obtain or retain an equity stake in the company.<sup>5</sup>

#### i) Private Equity Funds

Private equity funds are fixed-life funds that raise capital to acquire equity stakes (often involving control or full ownership) in companies, usually selected for their potential for high growth and strong returns, with a view to achieving a gain on their exit from those equity stakes over a relatively short term.<sup>6</sup> Broadly, private equity funds come in two forms. Captive private equity funds are set up and owned by institutions such as banks and pension funds, and only invest on behalf of their institutional parent companies (e.g. Barclays Private Equity). Other private equity funds are set up by independent management companies and raise funds from a mix of independent investors. Examples of large, well-known, independent private equity firms are Blackstones, 3i and Kohlberg, Kravis, Roberts & Co (KKR).

#### ii) Forms of Investment

Private equity spans a whole spectrum of investments at many stages of the life cycle of a company – from start up or seed capital for newly formed ventures, to expansion or development funding for existing businesses looking to grow, to buy-outs (acquisitions) of established companies or their subsidiaries and acquisitions of distressed companies.

#### iii) Contrast with Venture Capital

Venture Capital (VC) has often been used as a synonym for private equity (reflecting the early focus of private equity on investment in new ventures and the provision of growth capital), but is merely one form of private equity investment.

VC is now usually used to refer to start-up and growth capital invested at critical points of expansion. In VC transactions, a private equity fund will often only take a minority stake in the business (as VC is traditionally seen as the more risky arm of private equity), whereas in buy-outs private equity funds will usually acquire a majority or controlling stake.

#### iv) Forms of Buy-out

Buy-outs represent the largest total share of investment by private equity firms,<sup>7</sup> and are the activity that has brought the greatest scrutiny of private equity by media and regulatory bodies. Different forms of buy-outs are categorised mainly on the basis of the origination of the management who will hold an equity stake:

- A management buy-out (MBO) is one in which the existing management is involved in the buy-out from the current owners of a target using funding provided by a private equity fund.
- In a management buy-in (MBI), the private equity fund brings in a new external management team. This usually comprises individuals with a proven track record of expertise and experience within the relevant sector or with a required set of skills.
- A buy-out/buy-in (BIMBO) is a mix of the previous two, with the management team comprising existing and external management.
- An institutional buy-out (IBO) is the takeover of a company by a private equity fund.

#### v) Creation of Private Equity Funds

A private equity firm will create a fund and seek investors who are willing to commit money. These monies will be invested in targets to be subsequently identified by the private equity fund. In 2006 pension funds represented the largest source of funding for UK private equity funds (29 per cent of all funds raised), followed by fund of fund investments (16 per cent), banks (10 per cent), government agencies (9 per cent), insurance companies (9 per cent) and corporate investors, private individuals and academic institutions (representing 4 per cent to 6 per cent each).<sup>8</sup>

Limited Partnerships (LPs) are the most common vehicle for institutional investors, generally established in a tax-friendly offshore jurisdiction. The private equity firm will manage the fund and is referred to as the general partner, with each separate investor being known as a limited partner. Commonly, the partners

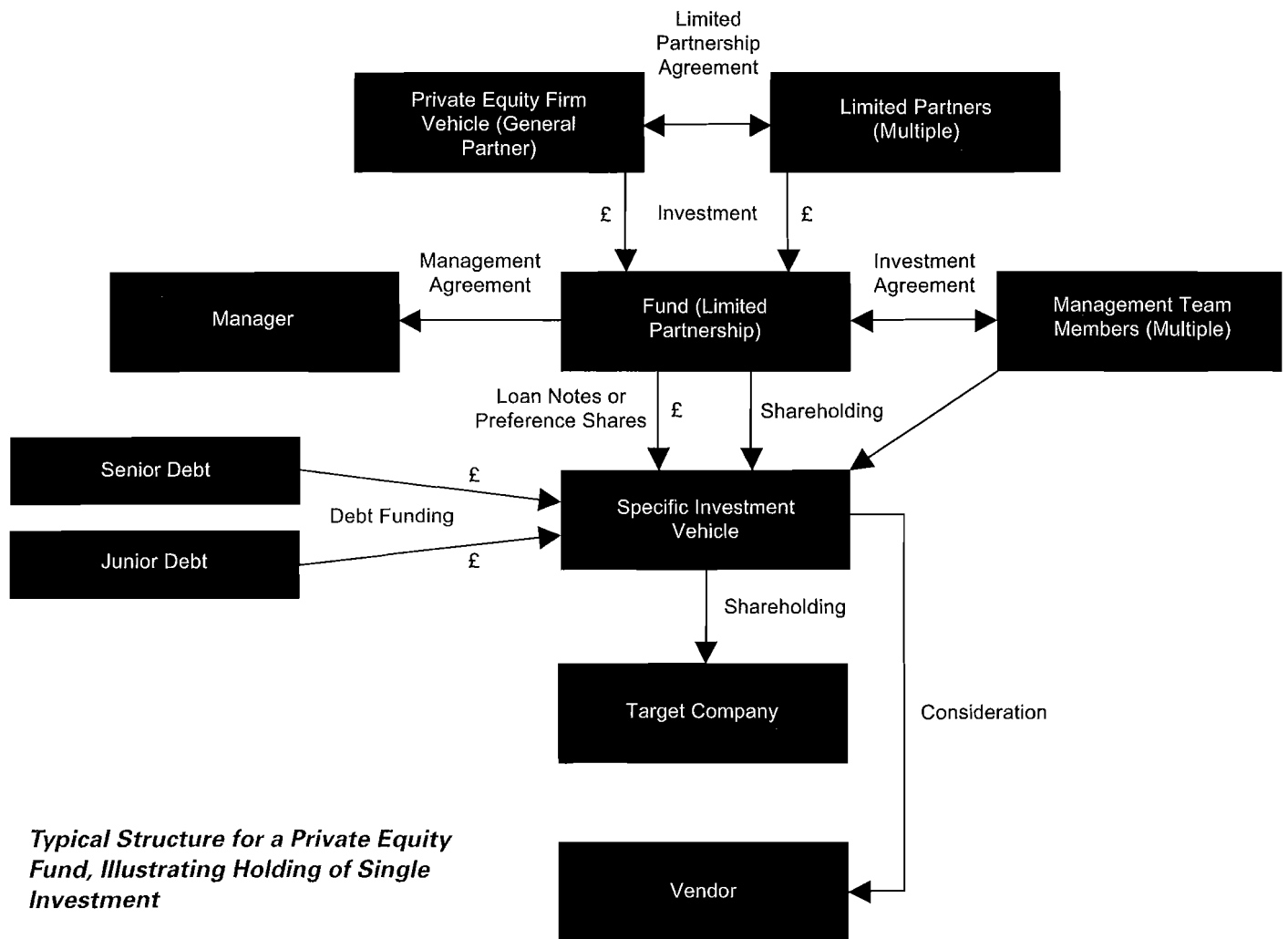
<sup>4</sup> *Private Equity: A Transactional Analysis*, 2007, Globe Business Publishing Limited at p. 5.

<sup>5</sup> David Walker, *Guidelines for Disclosure and Transparency in Private Equity*, (November 2007).

<sup>6</sup> *The Implications of Alternative Investment Vehicles for Corporate Governance*, a report for the Corporate Affairs Division of the OECD by the Centre for Management Buy-out and Private Equity Research (CMBOR) at Nottingham University Business School.

<sup>7</sup> *A Q&A guide to private equity law in the UK (England and Wales)*, Practical Law Company (1 November 2007).

<sup>8</sup> *Report on Investment Activity 2006 – Summary of Results*, BVCA, 2006.



**Typical Structure for a Private Equity Fund, Illustrating Holding of Single Investment**

of the private equity firm and senior staff or executives will also invest as a limited partner in the private equity fund, so as to align their interests with that of the fund investors and to provide them with rewards for good investment choices and management. The investment committee of the private equity fund manager will decide on what investments the fund will make, based on the investment parameters agreed amongst the fund investors in the investment management agreement. The private equity fund's lifespan (usually around 10 years) is set at the outset and usually comprises an investment period of 5 years during which the fund manager may draw down investors' commitments to fund new investments. The investments made by the fund are realised during the remainder of the fund's life and the original capital investment amount and profit distributed to the investors.

## Structuring private equity deals

### i) A Mixture of Equity and Debt

The acquisition price for target companies in buy-outs is usually funded by a mixture of equity capital (provided by the private equity fund as well as by management) and debt (provided by banks or other financing institutions). The proportion of equity to debt varies for each transaction

depending on the size and nature of the transaction and on tax considerations. In VC transactions, very little or no debt is used in the acquisition – mainly because the target company has limited assets against which to secure the debt. In buy-out transactions the level of debt to equity financing can range from 50 per cent debt / 50 per cent equity to as much as 80 per cent debt / 20 per cent equity, although the current constraints on funding lines is resulting in transactions proceeding, to the extent that they proceed at all, with lower debt/equity ratios than have been seen in recent times.

### ii) Holding Company Structure

Because of this layering of equity and debt, a new structure of holding companies is usually set up to help protect the hierarchy of rights of the various parties providing funding. In smaller transactions, the structure and arrangements will be relatively simple with mainly equity and shareholder loans being used with sometimes an element of senior debt. However in mid-to-larger transactions the equity and debt arrangements can be multilayered and more complex using both senior and junior debt and/or other more exotic financing arrangements requiring a more sophisticated structure. Broadly, the structure will look something like this: the private equity fund and limited

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partners establish and invest in a fund vehicle (the limited partnership referred to above), with the relationship between them governed by a limited partnership agreement. Their subscription monies and others monies are then advanced by the fund by way of loan notes and/or redeemable preference shares (all referred to as equity funding) to a newly established specific investment vehicle. Management of the target company will be offered an equity stake in the investment vehicle under the terms of an investment agreement in order to align their interests with those of the private equity fund. Loans from banks or other financial institutions are made to the specific investment vehicle. The investment vehicle then uses the debt and equity finance to acquire shares in the target company. (See diagram of a simplified structure, p29.)

A further element of debt may come into the equation if the seller agrees to defer payment of the consideration (referred to as "vendor finance").

### iii) Three Elements to a Buy-out

Because of the use of equity and debt funding, there are essentially three elements to a private equity buy-out:

- 1) equity;
- 2) debt; and
- 3) actual acquisition of the target company.

## 1) Equity arrangements

The most important document, in this context, is the investment agreement between the private equity fund and the management shareholders, which sets out the terms on which each party will subscribe for an equity stake in the investment vehicle and governs the relationship between the parties as the shareholders of that company.

### a) Veto/Approval Rights

One of the key matters with which a private equity fund will be concerned, is control over the target company and, in particular, over the board of that company. Where a private equity investor does not control the majority of voting rights, the investment agreement is used to secure veto rights so that the private equity fund's approval is required before the company can take certain actions, such as:

- the issue of further shares;
- the appointment or removal of directors;
- entering into a transaction under which the company will incur a debt or involving expenditure over a certain amount;
- the sale of company assets;
- substantially altering the company's business; or
- putting the company into liquidation.

Some private equity investors will seek board representation, whilst others will avoid it because of the potential for personal liability for directors. Irrespective of that preference, the private equity investor will invariably seek to secure rights to step in and take control in "emergency" situations.

Key to the equity arrangements are the directors' service contracts and provision in the investment agreement for the compulsory acquisition of a manager's shareholding if he leaves the company before a certain time. These provisions are intended to serve as an incentive to remain with the business (or at least a disincentive to leaving early). If a person is a 'good' leaver (e.g. he is unfairly or wrongfully dismissed or is forced to leave due to injury or illness) then he will obtain a higher price for his shares (usually the higher of fair market value or the amount he actually paid for them) whereas if he is a 'bad' leaver (e.g. he resigns or is dismissed with cause) he will obtain less for his shares – at worst only par value. Standard restrictive covenants will prohibit managers from competing with the business both during the time of their employment, and for a period after, as well prohibiting them from soliciting customers or employees of the business. The investment agreement also imposes various obligations on management, including regular reporting obligations to the private equity fund.

### b) Exit

A private equity investor will also want to ensure that it can control the timing of its exit from its investment and deliver the whole of the company to any purchaser. To this end, the investment agreement will usually include "drag along clauses" which enable the private equity investor to require management to sell their shares to the same person, on substantially the same terms and at the same time, as the sale of the private equity investor's shares. Management may, at the same time, want to negotiate a "tag along" clause so that they can elect to participate in any sale of the PE investor's shares on no less favourable terms.

### c) Anti-dilution and Restrictions on Transfers of Shares

In deals where the private equity investor does not hold a controlling stake (most commonly in venture capital transactions), the private equity investor will, as an alternative to absolute veto rights on share issues, insist on anti-dilution provisions which mean that it can participate in any further round of capital raising and that there will be an adjustment to the private equity investor's shareholding if shares are subsequently offered to other parties at a lower price per share than was paid by the private equity investor.

The investment agreement and articles of association will also contain restrictions on the transfer of shares. These restrictions usually take the form of either standard pre-emptive rights under which any shareholder wishing to sell its shares must first offer them to existing shareholders. Typically there will also be an outright prohibition on managers selling or transferring their shares prior to the exit of the PE investor, except in respect of a narrow range of permitted transfers (such as transfers to family members or a family trust for asset planning purposes).

#### d) Warranties from Managers

In MBOs, the private equity investor will require the managers to give warranties with respect to the target company. These will usually be negotiated at the same time as the warranties given by the seller and will focus on whether the business plan for the target company is realistic and achievable and the accuracy of the due diligence reports and key information disclosed to the private equity investor during the acquisition process. The purpose of these warranties is to provide a remedy to the investor and to encourage disclosure by management. Managers' liability is usually capped at or below the amount of the equity they have contributed and it is rare that action for breach of warranty is taken against management, unless false information was fraudulently or deliberately given. However, it is not all one-way traffic. Management's detailed operational understanding of the business means that it is often critical to both the private equity investor and the project's financiers that key management remains with the business. It is important, therefore, to ensure that any package put to management offers a sufficient incentive to stay. The following matters are likely to be considered by management in evaluating any proposal put to them by a private equity investor:

- What impact will the terms of any preference shares issued to the private equity investor or the repayment of loan notes have on the potential for dividends to be paid to managers?
- Has a "ratchet" been offered? This is an increase on a manager's shareholding on exit if a certain threshold level of return for the PE investor has been reached. Is it clear how the ratchet mechanism will operate in practice?
- Does the investment agreement provide managers with robust "tag-along" rights? If the PE investor sells its shares, can the managers sell their shares on terms no less favourable?
- Is the salary on offer at the proper going rate? Are the terms of any new service contract appropriate? As always, important issues will include notice periods, holidays, and restrictive covenants.
- When will a manager be a 'good leaver' / 'bad leaver'? If a manager is forced to sell, what will he/she receive for their shares? How long is the manager tied-in for? Do shares "vest" in the manager over time or will all of their shares remain subject to the 'good leaver' / 'bad leaver' provisions?
- If a fellow manager leaves, will his/her shares, or at least a portion of these shares, be distributed among the remaining managers or kept aside for the new manager?
- What warranties and relevant disclosures are the managers required to provide? Should a manager be sharing joint and several liability with their fellow managers? Even though it may be unlikely that a manager will be sued in practice, any breach of warranty will be detrimental to the relationship with the private equity investor. Managers will naturally be keen to negotiate a cap on any potential liability.

- Do "step-in" rights give the investor the right to take control only in true emergency situations? Are they sufficiently confined so as not to apply on technical breaches and slight under-performances?
- Are reporting obligations to the investor clear and reasonable? They should not be unduly onerous so that they detract from managers concentrating on the job.
- Do managers have the freedom necessary to run the day-to-day operations of the business or are managers forced to obtain the approval of PE investors for too many key activities?
- Do the investment agreement and the articles of association allow permitted transfers of shares to a family member or trust?
- Who pays for a manager's legal and other advisory fees? Will they have to pay PAYE or NIC on them?

## 2. Debt arrangements

Debt is primarily used to finance the consideration payable for the shares of the target company but it is sometimes also used to provide working capital to the target company following completion.

The main debt is referred to as "senior debt" and will usually be a secured term loan which will rank in priority over any other debt as well as over any loan notes or redeemable preference shares provided by the PE fund. The target company and its subsidiaries will guarantee the bank loans and their assets will be used as security for such loans.

Any other source of debt is known as junior debt. This is usually mezzanine debt and, although usually also secured by the same assets as senior debt, it ranks below senior debt but above equity capital of the PE investor (including loans notes or redeemable preference shares). In many instances, junior debt involves few if any covenants with the higher risks involved for the lender of junior debt being reflected in higher interest rates. In respect of mezzanine finance, in order to ensure that the higher risks receive a higher reward, the lender will also often be granted warrants, giving it the right to participate in equity share capital and, accordingly, in the up-side of any increase in the value of the enterprise on the private equity investor's exit.

The documents required to put these arrangements in place will usually consist of the following:

- a facilities agreement for each loan;
- guarantees;
- security documents (most often debentures creating fixed and floating charges in favour of the lender); and
- an inter-creditor agreement regulating the ranking or subordination of all debt and security.

These documents will also place restrictions on what the target business is permitted or not permitted to do while the debt is outstanding. For example, the business may be prohibited from taking out further loans or selling company assets, may be required to maintain certain debt/equity ratios and will be subject to comprehensive reporting obligations to the financiers.

### 3. Acquisition documents

The key acquisition documents are the share sale agreement and tax deed (governing the liability for and conduct of any tax liability of the company arising post-completion). The execution of these documents will be conditional upon the completion of the investment agreement and debt agreements. Usually, documents such as the investment agreement and share purchase agreement will be fairly standard institutionally based documents, with PE investors unwilling to stray from precedent. However, as with any deal, the terms negotiated depend very much on the parties' relative bargaining position.

Essentially the key transaction documents are similar to normal M&A agreements, although the role of management adds a certain degree of complexity in relation to MBOs. As the transaction proceeds towards completion, the management team becomes increasingly conflicted between its obligations and duties to its employer (the seller) pre-completion on the one hand, and a desire to remain in favour with their prospective employer (the private equity buyer) post-completion on the other hand. These tensions arise particularly in relation to the giving of warranties and disclosure against those warranties, where the interests of the buyer and seller are diametrically opposed, and management has a central role to play due to its detailed knowledge of the target company. Commonly this results in tri-partite warranty arrangements whereby management also provides warranties to the buyer, which need to be negotiated with management as part of the investment agreement, along with the terms of the equity investment, their remuneration and matters such as restrictions on transfers of shares and non-compete undertakings (as previously discussed). Clear guidelines need to be established and adhered to regarding the communications between the parties during this process. Sellers should expect in any event that the transfer of alliances may occur mentally and emotionally on the part of management well before completion.

### The Future - Focusing on the Fundamentals

While private equity transactions can originate in a variety of ways, three-quarters of the deals covered by a study of 2006 private equity exits resulted from proactive origination strategies on the part of the private equity funds, including

company or sector tracking, building relationships with management or introductions with established contacts. Only 11 per cent of the deals resulted from private equity investors starting work during the formal sale process.<sup>9</sup>

#### i) A More Conservative Future

The current climate has seen private equity deals dry to a trickle. As that trickle increases, it is likely that the focus of buyers will turn to businesses that are less vulnerable to the effects of the downturn in the economy, that deals will proceed with lower leverage multiples, that credit costs will increase and that funds will have to contribute higher amounts of equity to deals.<sup>10</sup> Also, it is to be expected that banks will focus on credit risk more than has been previously the case.

#### ii) Due Diligence

Due diligence in private equity transactions has always tended to be relatively rigorous, with private equity funds employing experienced professionals and consultants to carry out due diligence and spending significant amounts of money and time on these enquiries. The importance of due diligence is likely to increase in the tighter future market. Recent studies highlighting the value that can be gained from improvements in productivity serve as a reminder of the importance of a thorough operational due diligence, in addition to the usual legal and accounting due diligence and indicate that buy-outs improve productivity. According to the studies, the total factor productivity of MBO targets is approximately 2 per cent lower than comparable plants before the transfer of ownership. After the MBO, plants experienced substantial increases in productivity of approximately 90 per cent.<sup>11</sup> Private equity investors looking to excel in a difficult market will need to focus on operational due diligence in addition to the more traditional analysis of matters such as:

- What is the bad debt and economic slowdown exposure of the target?
- Do the employees all have contracts? Are there proper procedures in place to deal with employee grievances, disciplinary matters and dismissals? Are bonuses linked to company goals?
- Are the company's relationships with its customers properly documented? Are customer contracts in a standard form with standard terms and notice periods throughout? To what extent is the company able to dictate the terms of trade with its customers?
- Is the company in compliance with all legislative requirements? Are regular reviews of compliance matters held?

<sup>9</sup> See fn 1.

<sup>10</sup> Annette Kurdian and Nick Syson "A Climate Shift in Deal Terms", *PrivateEquityOnline*, (4 February 2008).

<sup>11</sup> Professor Mike Wright, Andrew Burrows, Dr Louise Scholes, Margaret Burdett, and Karen Tunc *Management Buy-outs 1986-2006; Past Achievements, Future Challenges*, CMBOR (June 2006).

- Are the IT systems adequate and robust? Are all relevant licences held for software? Are the systems compatible with those that any customers / suppliers use?
- Environmental matters: is waste being disposed of properly? In the current climate, have measures been introduced to address the environmental impact of the business and its carbon footprint (e.g. through use of low emission vehicles, well insulated buildings)?
- Are suppliers benchmarked to make sure they are aligned to the organisation's own key performance indicators in the way they provide products and services?
- Are competitors benchmarked to ensure that the organisation is not selling itself short, and is staying ahead of the competition?

### iii) New Provisions: Material Adverse Change

As the European M&A market moves to a buyers' market from a sellers' market, buyers and their sponsors should be pushing for the incorporation of provisions more commonly seen in US deals, such as finance, due diligence and material adverse change conditions that allow the buyer to walk away should the business change materially post-signing but before conditions precedent have been satisfied, and break fees that would require the sellers to pay fees to cover the buyer's due diligence costs where those conditions are not satisfied. The potential benefit of a material adverse change clause is amply illustrated by the acquisition of Guidant Corporation by Johnson & Johnson in 2005. Having agreed a price of US\$25.4 billion in December 2004, an article in the *New York Times* in May 2005 triggered investigations by the FDA, US Department of Justice and New York's Attorney General and a subsequent product recall, which saw Guidant's third quarter results down almost 60 per cent on the prior year. Johnson & Johnson sought to terminate the agreement on the basis that Guidant had suffered a material adverse event and used the leverage provided by the clause to good

effect in the ensuing negotiations: the deal proceeded at a reduced price of US\$21.5 billion (a saving of almost US\$4 billion for Johnson & Johnson as purchaser).

### iv) Less Equity for Management?

The ability to introduce a strong management team to implement a focussed strategy and improve operating efficiency in target companies is commonly seen as one of the largest elements of the value added by private equity firms, and the provision of equity incentives to broader groups of senior and middle management has become one of the key differentiating features of the private equity model. However, the operational importance of management to the target business going forward is no longer directly reflected in the proportion of equity held by managers. While buy-outs are still categorised by reference to the source of the on-going management (e.g. MBO, MBI, BIMBO), private equity firms have in practice increasingly initiated deals themselves. As a consequence, the percentage of equity held by management post-acquisition has decreased. Where once management might have held between 25 per cent and 49 per cent of the equity, that stake is now typically in the range of 5 per cent to 10 per cent (although still greater than what would be available for managers of public companies).

### v) Exit strategy

The need to exit an investment and realise any value created is integral to the private equity model. The current market makes exits more difficult, so investors may have to structure deals so that they will hold their investments for a longer period, while waiting for the market cycle to turn. Alternatively private equity firms may have to find alternatives to secondary exits, should opportunities for trade sales dry up. With the volume of deals that will be looking to exit in the next few years, IPOs may not be the solution as the market could quickly become overrun with new offers. As always, it will be important to focus on the fundamentals: planning early with attention on structuring and positioning the business to make it attractive to likely buyers. 