a few things you should know …

M&A Deals with Private Equity Funds

Private equity funds have been a dominant force in M&A transactions for many years, and their influence is growing as more (and larger) funds continue to be raised. In this edition of *A Few Things You Should Know*, we provide practical insights for doing M&A transactions with private equity buyers.

- **IN A NUTSHELL**
  A private equity ("PE") fund is typically a partnership that has secured commitments from institutional and high-net-worth investors (limited partners, or "LPs") to acquire operating businesses or invest in other alternative asset classes. Here, we focus on leveraged buyout funds that acquire controlling stakes in private businesses using both equity from the fund and debt placed with other financing sources. The fund sponsor decides what assets to acquire and then draws down from its LPs to make the investment. The typical "investment period" (i.e., when the sponsor can draw down for new deals) is 4-5 years. After the investment period, the sponsor typically has another 4-5 years to dispose of those investments. The sponsor receives management fees from the LPs, but a PE fund's primary upside is through carried interest (a share of profits after the LPs are repaid). PE funds are leanly staffed, and most will engage "operating partners" to provide operational assistance and oversight to the portfolio.

- **ALL FUNDS ARE NOT MADE EQUAL**
  A traditional PE fund is a committed fund (a/k/a "blind pool") in which the LPs have signed binding commitments to fund any deals sourced by the fund sponsor that fit basic investment parameters. There are many other sponsors in the market who operate as "fundless sponsors" or "independent sponsors"—namely, they need to raise equity from their investor network to close the deal. Some independent sponsors have little problem raising equity and may be an excellent partner, but their funding limitations could be a meaningful factor when comparing bids from multiple buyers. Often it is not obvious from a fund's website, but an experienced PE lawyer or investment banker can usually identify an independent sponsor.

- **SPEED DATING**
  A healthy middle-market company may have hundreds of potential PE buyers to contact and multiple bids from high-quality funds that are tough to distinguish. The PE funds will have limited time to validate financials and conduct diligence, and will often overshoot on valuation. Strategic buyers are guilty of this as well, but it can be a recurring issue with PE funds in particular. Their deal volume is much higher—a PE fund may actively review hundreds of deals per year—and they have greater sensitivity to broken deal costs, which need to be called from LPs. Before entering into exclusivity with a PE fund, the client (or the banker) should ensure that the fund is truly committed and well informed. *Where possible, exclusivity provisions should include milestones to keep the buyer on task throughout the exclusivity period (e.g., diligence confirmation, markup of purchase agreement, and preparation of management equity/employment agreements).* Sellers should expect that PE fund buyers will demand access to the management team early and often in the due diligence process, particularly if the founder or majority owners will not have a continuing role with the target company after closing.

- **FROM SIZZLE TO CHISEL**
  The primary valuation metric for a PE fund is a multiple of earnings before interest, taxes, depreciation, and amortization ("EBITDA"), often to a greater extent than a strategic buyer. PE funds are more allergic to short-term financial swings and will scrub the financials and add-backs extremely carefully. "Selling the sizzle" may result in a lot of bids, but there will be little margin for error in monthly performance. One monthly "miss"—even a minor one—can

cause a PE fund and its lenders to slow the process down to await other potential ghosts lurking in the business or the financials. In addition to presenting realistic projections and early disclosure of major business/legal risks, sellers should consider pre-packaging as much diligence as possible: this could include Phase Is, disclosure schedules, and a seller-commissioned quality of earnings report. Doing this will shift some cost to the seller (possibly recouped at closing), but the seller's return on investment can be significant.

- **USE OF LEVERAGE**
  Leverage can have a dramatic impact on fund returns, and most funds will use at least one layer of secured debt to close a transaction. Funds typically have many lender relationships and can obtain multiple lender proposals fairly quickly. The placement and closing of debt financing will be critical to the success of a deal. Many PE funds have the ability to forego the debt process and close with equity from the fund, but they rarely have any appetite to do so. *Even if the buyer's Letter of Intent states that debt financing is not a condition to closing, a seller/target company should expect that the transaction will be at risk if the debt financing is not obtained on favorable terms.*

- **FACT OF LIFE—MANAGEMENT FEES**
  In addition to management fees from their LPs, most funds will charge advisory/monitoring and transaction fees to the portfolio company. Advisory/monitoring fees may be a fixed monthly, quarterly, or annual amount, or may be based on a percentage of EBITDA. These fees are usually justified by actual services, but the PE fund will not be receptive to affirmative service obligations that may be common in an arm's length service agreement. *Portfolio company fees are a widely recognized add-back to EBITDA, so they will not adversely impact management's EBITDA projections or any earnout payments.*

- **MANAGEMENT INCENTIVES AND POST-CLOSING EQUITY HOLDER RIGHTS**
  One of the key advantages of a PE fund relative to a strategic buyer is the ability to provide a meaningful upside and greater job security to management. A PE fund will invite (and often require) the target company's management team to roll a portion of their equity stake into the post-closing enterprise and will typically offer incentive equity to the management team. Incentive equity comes in many flavors, depending on the structure, and can include profit interests, options, phantom equity, and discounted stock purchase rights. However, only a large minority holder should expect to have meaningful veto rights attached to their equity, other than those related to affiliate transactions. In addition, controlling the exit is considered a sacred right of PE funds. For rollover sellers (even with large-percentage ownership), any rights that could disrupt the exit process are unusual and will be strongly resisted.

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A FEW THINGS YOU SHOULD KNOW is a periodic publication of the Mergers & Acquisitions practice group of Perkins Coie LLP. Each edition covers a discrete topic related to M&A, including identifying key issues to be addressed and related market trends. We also share our experience-based insight into current approaches to resolving common deal issues. *A Few Things You Should Know* is intended as a high-level issue-spotting guide and quick-reference resource for buyers, sellers and their professional advisors. Please contact the Perkins Coie LLP attorney listed above for more information.