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It is no surprise that the abrupt conclusion of the golden age of private equity brought about by weakness in the global credit markets has seized headlines. After all, the once furiously pumping pistons of the private equity engine helped drive the 2004–2007 M&A boom. That this engine has since sputtered is a significant development in the world of buyouts. However, a related, less-often-told story that merits notice as well is how PE firms, facing an era of diminished credit and the ascendant influence of strategic buyers, are departing from the highly leveraged, all-cash buyout model that prevailed during the boom period in order to complete deals.

Making use of flexible forms of deal consideration, financial acquirers appear to be increasingly incorporating earnouts and seller financing into the consideration they offer targets to boost the “headline value” of their bids and reduce the amount of the purchase price required to be financed by third parties. In addition, private equity buyers are, with mounting frequency, employing a broad range of flexible investment strategies, which are also designed to lessen the need for upfront third-party acquisition financing. These strategies include requesting that sellers “roll over” significant stakes in target companies, the purchase of minority equity positions in target companies, and making all-equity investments.

Dealmakers of all stripes would do well to take stock of how and why private equity deal-making activity has evolved since the credit markets contracted in order to ready themselves to make use of, or respond to, some of the flexible techniques that have gained currency recently and appear to be positioned for continued growth in the months to come.

BOOM PERIOD PE BUYOUT MODEL ENCOUNTERS HEADWINDS

During the boom period, leading buyout shops came to rely on readily accessible leverage to reduce the equity capital they invested to acquire target companies and magnify returns. Following the boom period, however, instead of being able to easily slake their thirst for debt as they had before, the credit spigot was cranked down and these same buyout shops were served a toxic cocktail of imperiled lenders and languid capital markets. Although the credit markets have stabilized somewhat since their darkest hour, they remain less than robust and the debt that is currently available is, in many instances, priced on terms considerably less attractive than the terms offered during the boom period. At the same time, healthy strategic acquirers—boasting cash on their balance sheets and ready-made financing in the form of availability under existing, already-priced

revolving lines of credit—have crashed the M&A party, becoming increasingly assertive as the deal-making hegemony of private equity firms recedes.

As if that wasn't enough, many private equity firms have been compelled of late to dedicate considerable attention to the needs of their own vulnerable portfolio companies, seeking to improve their operations, guiding them through restructuring transactions with restive lenders, and evaluating whether to contribute more capital to them in order to preserve value. Against this backdrop, it is not difficult to understand why acquisitions by private equity purchasers have tapered off. Indeed, private equity buyout activity reportedly reached a seven-year low in 2009.

Still, many funds remain flush with committed capital following strong fundraising results in recent years, and current market conditions offer some compelling values for purchasers able to realize them. Consequently, financial buyers have sought to continue to actively deploy capital in spite of the reduced availability of credit, relying increasingly on creative approaches to stretch the value of their acquisition offers or departing significantly from the investment strategies many of them routinely employed during the boom period. Several of these techniques are surveyed below.

PAYING LATER (MAYBE) WITH EARNOUTS

The use by private equity purchasers of earnouts both limits their funding obligations at closing—and thus dependence on third-party financing—and reduces their exposure to future operational uncertainties at target companies. Although the terms of earnouts can vary considerably, under one common earnout arrangement, a portion of the purchase price for a private company target is deferred and made contingent upon the acquired company's attainment of financial performance benchmarks at one or more specified intervals following the completion of the acquisition. In such an arrangement, the buyer and seller share a measure of the risk of the target's future financial performance, with the buyer ultimately paying an increased purchase price only if the target achieves agreed-upon financial milestones.

From the financial buyer's perspective, earnouts also have the salutary quality of providing selling stockholders who remain in management positions following the acquisition with a powerful incentive to drive strong results at the acquired business. Since private equity

purchasers frequently depend on the continued effective service of existing owner-managers following acquisitions, this can be an important advantage. In exchange for these benefits, financial buyers often must offer more total potential consideration—measured to include the assumed payment of the earnout—than would a purchaser offering to pay entirely in cash at closing.

The May 2009 agreement of Kohlberg Kravis Roberts & Co. to acquire Oriental Brewery, Anheuser-Busch InBev NV's South Korean brewery, in exchange for \$1.8 billion featured an earnout provision enabling Anheuser-Busch InBev to retain a continuing economic participation in Oriental's future performance. Similarly, Filtrona plc's April sale of its subsidiary Filtrona Extrusion Inc., a manufacturer of plastic products, to private equity firm Saw Mill Capital Partners featured an earnout representing up to approximately 26% of the total consideration payable in the deal.

USING SELLER PAPER TO WRAP DEALS UP

Seller financing has also figured importantly in a number of acquisitions completed recently by financial buyers. In a deal involving seller financing, the seller is asked to participate directly in the financing of the transaction by agreeing to accept a debt security or promissory note (sometimes referred to as "seller paper") issued by the target as one component of the total purchase consideration the seller will receive in the transaction.

For instance, in September 2009, an investor consortium led by private equity firm Silver Lake acquired a controlling stake in Skype Technologies SA, an Internet calling business, from online auctioneer eBay Inc. for \$1.9 billion in cash and a \$125 million seller note. In addition, under the terms of Anheuser-Busch InBev's sale of Oriental to KKR, Anheuser-Busch InBev agreed to take seller paper in payment of \$300 million of the \$1.8 billion price tag.

Utilizing seller financing enables a private equity buyer to shift to the seller a portion of the overall financing that it may otherwise be required to obtain from third-party lenders or the capital markets. This privilege is rarely costless to the acquirer. In exchange for financing a portion of the sale consideration, a seller may insist on seller paper featuring an attractive rate of interest or may demand a higher aggregate purchase price for its business than it otherwise would have required.

Invariably, the terms of seller paper are carefully negotiated. However, in transactions in which the target has significant debt that will remain in place following the closing or in deals in which it is contemplated that third-party acquisition financing will be obtained, it is not uncommon for interest payments on the seller paper to be permitted to be made—if they are permitted to be made at all prior to maturity—only in narrowly circumscribed circumstances or only in-kind, and for the debt itself to be unsecured, non-amortizing, subordinated to much or all of the target's other debt, and issued without significant restrictive covenants protecting it. Such terms often enable the target to incur and service the debt represented by the seller paper in compliance with the restrictive covenants that may be contained in its existing debt documentation and facilitate the successful marketing of acquisition financing to prospective third-party lenders by both offering these investors a comparatively privileged position in the target's capital structure and reducing the extent to which the seller paper imposes short-term liquidity pressure on the target.

Sellers in such transactions will frequently press for an interest rate—even if interest will not be payable in cash in the near term—that appropriately compensates them for the seller paper's compromised position in the capital stack and the limited contractual protections it enjoys. Sellers may also seek the right to require that the seller paper be repaid upon the occurrence of certain trigger events, such as a change of control at the target, a substantial equity sale by the private equity sponsor, or a refinancing of other debt at the target.

By contrast, in deals in which there is no material continuing debt at the target and no third-party acquisition financing or in transactions in which the seller financing amounts to a considerable portion of the total purchase price, the seller paper may be structured to afford sellers a broader suite of protections, such as cross-acceleration provisions, restrictive covenants, seniority in right of payment, and collateral support.

BUYING A LITTLE BIT LESS OF A GOOD THING WITH MINORITY STAKE PURCHASES

Financial buyers have, with escalating frequency of late, turned to purchases of minority stakes in both public and private targets as alternative means of putting their clients' money to work. Naturally, when compared with

the acquisition of all of the equity interests in a target company, this minority position investment strategy lessens the reliance of purchasers on external financing by reducing the total size of the investment made. These investments may also offer funds the opportunity to achieve exposure to promising companies that are not receptive to change-of-control transactions. In exchange for their minority investments, private equity firms often insist on obtaining some measure of influence over the affairs of targets, such as board and committee representation, pre-emptive rights with respect to future equity issuances, and management consultation rights.

For targets, some of which are at least as bedeviled by the credit crunch as private equity firms, minority investments by financial buyers can represent an efficient and expeditious alternative means of raising capital. These transactions also enable investees to avail themselves of the additional financial and operational expertise sophisticated buyout shops can provide.

Private equity firms make minority investments in privately held companies using a variety of techniques, but they make minority investments in public companies largely in the form of private investment in public equity, or PIPE, transactions. In PIPE transactions, financial buyers often purchase at a discount a substantial position in a private placement of either the common stock of a target or other securities, such as preferred stock or bonds, convertible into the target's common stock. The purchased securities commonly enjoy registration rights to ensure that private equity firms can achieve an orderly exit in the future should they choose to reduce or dispose of their investments through the capital markets.

Recent examples of private equity minority stake purchases include PE firm TA Associates' October 2009 \$200 million investment in AVG Technologies NV, a Dutch computer security software company. TA Associates also made a \$60 million minority investment in Teoco Corp., a provider of software and services to telecommunications and cable companies, in October 2009. In a PIPE deal announced in July 2009, Warburg Pincus agreed to invest \$115 million in banking company Webster Financial through the purchase of common stock, junior non-voting preferred stock, and warrants. Upon completing the investment, Warburg Pincus held about 15% of Webster Financial's common stock and a seat on its board.

Despite their increasing prevalence, or perhaps because of it, minority stake investments by financial

firms—especially those made in public companies—have not escaped the occasional barbed critique. Many buyout shops have carefully cultivated the belief among investors that their core skill set is used to best advantage when they acquire companies, drive governance, financial, and operational improvements, and then sell these same companies or take them public several years later. Some pundits have therefore questioned whether buyout firms, by taking non-controlling minority positions in public companies, have begun to stray from their primary buyout mission in order to instead make minority investments that can be replicated by investors without the aid—or management fees—of a private equity shop. However, defenders of these investments point out that private equity firms often add value for their limited partners by buying into the equity of public companies at a discount to prevailing trading prices and obtaining board representation to boot, enabling funds to guide companies and bring about improved results without footing the entire cost of acquiring them outright.

USING MAJORITY INVESTMENTS TO LEAVE MORE SELLER SKIN IN THE GAME

Another technique finding growing use in the hands of debt-starved financial buyers involves purchasing a controlling stake in a target and persuading sellers to indirectly participate in the financing of the acquisition by either “rolling over” or continuing to hold a significant portion of their equity. In other words, in these investments, rather than acquiring all or nearly all of a target’s stock, private equity firms instead effectively buy a majority position—frequently amounting to 55%-75%—in the target’s equity and the sellers continue to hold the remaining equity in the company following the transaction.

For a financial buyer, this approach can significantly reduce the overall cost of an investment—and the corresponding need for financing—while still affording it substantial control over the governance and operations of a target and the ability to exit in the future on its own terms. In addition, a majority stake investment aligns the economic interests of the financial buyer and those sellers who retain equity stakes in the acquired business, encouraging all equity holders to strive to achieve strong financial results for the company.

Of course, a majority stake investment is not suitable in all circumstances. Sellers wishing to dispose

completely of a business will not welcome a majority stake offer and the associated economic risk that continued ownership of a portion of the business represents. For these sellers, an offer from a strategic acquirer to buy all of the equity of the target—even if it will result in a purge of the management team—will be preferable. However, for seller-managers seeking a liquidity event, a financial partner, and continued participation in the management and potential upside of a target’s business, a majority stake investment by a financial buyer can prove to be attractive.

Recent transactions using the majority stake investment approach include the previously mentioned acquisition by an investor group led by Silver Lake of a 65% stake in Skype from eBay Inc. for \$1.9 billion in cash and a \$125 million seller note. In February 2009, an affiliate of Levine Leichtman Capital Partners purchased a controlling interest in Pacific World Corporation, a supplier of nail and beauty care products. As part of the transaction, the target’s management team rolled over a significant amount of equity. In a deal announced in June 2009, TPG Capital and Riverwood Capital agreed to acquire a 65% stake in privately held Aptina Imaging Corp., an imaging solutions business, from Micron Technology Inc.

THE LBO MAKES WAY FOR THE EBO

Turning the leveraged buyout model on its head and even spawning an addition to the contemporary lexicon of Wall Street, EBOs—or equity buyouts—involve the purchase of a target company without the use of any borrowed money. Transactions structured in this way eliminate altogether the need for private equity buyers to access the debt markets to fund their acquisitions and are appealing to sellers in that they are more certain to close than transactions dependent on third-party financing.

Prominent examples of all-equity buyouts attempted or completed since the credit markets became constricted include a September 2008 agreement by Bain Capital LLC and Hellman & Friedman LLC to acquire Lehman Brothers Holdings Inc.’s Neuberger Berman money management unit for \$1.85 billion. Ultimately, Neuberger Berman’s management team won out over Bain and Hellman & Friedman in a subsequent auction for the company administered by the bankruptcy court, but the two private equity firms had been poised to

fund the purchase price using only equity. In June 2008, ConAgra Foods Inc. sold its commodity trading unit to Ospraie Special Opportunities Fund, General Atlantic LLC, and Soros Fund Management LLC for \$2.8 billion in a transaction bankrolled exclusively with equity.

All-equity acquisitions, while comparatively easy for financial buyers to execute if they have sufficient dry powder at their disposal, can present other challenges for them. For example, in the absence of leverage, successful investments offer financial buyers a lower rate of return on invested capital than LBOs. In addition, EBO transactions may require financial buyers to put more capital at risk than they would have otherwise in a leveraged buyout supported by acquisition financing from third parties. Unleveraged acquired companies also forgo the favorable tax treatment accorded interest payments on debt.

However, although initially funded solely with equity, private equity buyers in EBO transactions often plan to put financing in place at, or execute leveraged recapitalizations of, targets subsequent to the consummation of the buyouts. For instance, following the closing of the ConAgra transaction, the target secured a \$1.5 billion asset-backed loan facility. Moreover, financial buyers relying on an all-equity investment strategy often will offer a purchase price based on a lower multiple than prevailed during the heyday of LBO activity several years ago. This approach enables buyout shops to

preserve acceptable rates of return on invested capital, especially if the financial performance of the target is temporarily depressed at the time of the acquisition and later rebounds.

CONCLUSION

Confronting a scarcity of credit and a changed M&A landscape, many private equity firms have adapted to the new realities of the market by deviating from the once *de rigueur* highly leveraged, all-cash buyout formula. In opting to make use of alternative forms of purchase consideration and flexible investment strategies, financial acquirers have set aside some of the received wisdoms about how they should deploy capital and have demonstrated that the present market will reward an agile approach that incorporates a measure of inventiveness. While the pendulum of buyout clout will not swing from strategic acquirers back to financial buyers anytime soon, private equity firms that employ flexible deal structuring techniques to execute promising investments are likely to hold their own in the challenging post-recession deal making environment.

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