The Private Equity vs. Strategic Buyer: Key Differences and Practical Considerations

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Presenter Biographies
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Josh is Vice President and Deputy General Counsel of Audax Group, a leading investor in middle market companies. Audax manages over $5.0 billion of assets through its private equity, mezzanine debt, and private senior debt businesses. Josh is responsible for the legal aspects of all of Audax’ private equity M&A transactions. Previously, Josh was with Ropes & Gray LLP in Boston for six years, where his practice focused on private equity M&A transactions. Prior to Ropes & Gray, he served as a law clerk to the Honorable D. Brock Hornby, United States District Judge for the District of Maine. Josh received a J.D. from Stanford Law School and a B.A. from Bowdoin College.
As head of Stradley Ronon’s private equity practice, Frank Bacelli focuses on the representation of private equity, venture capital and growth equity funds in middle-market investment transactions. Mr. Bacelli’s practice involves a full range of corporate transactions, including leveraged buyouts, venture and growth equity financings, mergers and acquisitions, and joint ventures.

He has extensive experience as lead counsel representing portfolio companies of private equity funds in add-on acquisitions and dispositions.

In addition to transactional work, Mr. Bacelli counsels a number of public and privately-held companies in day-to-day legal and commercial matters.
Mr. Watkins is senior strategic financial executive and CFO living in Washington, DC. His background includes extensive M&A and corporate development work at four public companies, new investment and portfolio company work at a billion-dollar private equity fund, executive financial leadership (CFO), and investment banking. He also founded and ran his own technology company for 6 years. Mr. Watkins has experience as the buyer, as the target, and as the intermediary in private equity deals.
Agenda

- The Strategic Buyer
- The Private Equity Buyer
- Transaction Structures
- A Primer on Leverage
- Life Under Private Equity Ownership
- Management’s Perspective
- Exit Readiness
- Key Takeaways
The Strategic Buyer
The Strategic Buyer

- “Strategic” = Corporate Buyer
  - Motive for purchase is to add a synergistic technology, business or market presence
  - Pays in all cash or cash/equity and buys 100% of the Target
  - Pay higher premium because resulting synergies and cost-savings may create greater value
  - Greater focus on the ultimate price paid and ability to claw back under indemnity
  - Will buy and hold for longer period, if not indefinitely
  - A competitor to the PE Buyer
The Private Equity Buyer
By and large, “Private Equity” refers to pooled investment vehicles, or “funds,” which acquire controlling or minority interests in mostly privately held operating companies.

- Private equity may be referred to broadly to include venture capital, growth equity, mezzanine lending and other private investment funds (e.g., real estate).

- A private equity fund is typically structured as a Delaware limited partnership, whose general partner (usually an LP or LLC) is comprised of private equity investment professionals (finance MBAs).

- Limited partners are passive investors with little say or role in the investment decisions of the fund.
Typical Fund Structure

- General Partner (LP or LLC)
- Limited Partners (Fund Investors)
- Manager (Employer of Fund Professionals)
- ABC Capital Partners Fund I, L.P. (The Fund)
The general partner and its professionals are responsible for:

- Raising capital for the fund from limited partners
  - Typically, “institutional investors” such as public pensions, endowments, foundations, and high net worth individuals
- Investing that capital in operating companies
- Managing the fund’s portfolio of acquired companies (referred to as “portfolio companies”) through board representation and as controlling shareholder
- Generating a return on invested capital through exit transactions (i.e., a subsequent sale, recapitalization or IPO of the portfolio company).
The Private Equity Buyer

- **Private Equity Buyer = Financial Sponsor**
  - Motive for purchase is to buy and sell within 3-7 year investment horizon
    - Provide eventual return on investment to PE fund’s limited partners
  - Seeks to buy control positions in operating companies
    - “Platform” vs. “add-on”
  - Pays in mix of cash and debt (“leverage”)
  - Tend to have investment expertise in specific industry verticals
  - View investments as partnerships with existing management and other stakeholders
Transaction Structures
“LBO”: The Traditional PE Transaction

- **LBO = Leveraged Buyout**
  - **Leveraged** = Debt in the form of senior credit taken on by the target to partially (but materially (approx. 55-65%)) fund the purchase price consideration. Can also include subordinated or mezzanine debt.
  - **Buyout** = Purchase of a controlling interest from the target’s shareholders with (1) proceeds from the leverage component described above and (2) the remaining consideration (approx. 35-45%) from the fund in cash (referred to as the equity component).
An Acquisition Transaction

- The primary transaction – an acquisition of the target company.
- May be a **stock purchase**, **asset purchase**, **merger**, **recapitalization** or “go-private”.
- Tasks and documentation are virtually the same as any M&A deal.

Fund creates a holding company to purchase the controlling interest in the target, allowing the fund to establish equity at the holding company level with terms and preferences advantageous to the fund, “rollover” management and incentivized employees.
“LBO”: The Traditional PE Transaction

- Any structural differences between PE and Strategic acquisition transactions?
  - Conceptually and mechanically no different
  - However, PE Buyer has greater incentive to be more “commercial” since employees are stakeholders
  - As a result, terms and conditions tend to be somewhat less onerous
    - As a financial partner, less inclined to seek indemnity from its management team
    - Sellers may not be locked up as long on escrow and indemnity
    - Fewer instances of earn-outs (which may be more easily measured by a corporate owner post-closing)
The Buyout: Three Transactions in One

- **A Credit Financing Transaction**
  - Senior bank debt and often mezzanine or sub debt
  - Secured by assets of the operating company
  - Equity of operating company pledged to lender
  - Negotiated intercreditor arrangements
  - Robust financial covenants and reporting requirements
The Buyout: Three Transactions in One

- **An Equity Exchange Transaction**
  - The capitalization of the holding company buyer requires a suite of new “equity” docs at the holding company level.
  - PE funds will typically ask some or all of the existing management shareholders to roll over a small portion of their equity for new equity in the holding company to align the interests of the buying and selling parties.
  - A Stockholders Agreement will provide the PE Buyer with restrictions on transfer by other owners, drag along rights in the event of a sale, and registration rights upon a public offering.
Diagram of LBO with Equity Rollover

- Fund
  - Holdco
  - Target

- Fund
  - Holdco
  - Target Stockholders

- Fund
  - Holdco
  - Target Stockholders

- Fund
  - Holdco
  - Target Stockholders

- Fund
  - Holdco
  - Target Company

- Senior and Sub Debt

Shares of Holdco/Cash

Shares of Target
“LBO”: The Traditional PE Transaction

- Role of Corporate Counsel in an LBO?
  - No different than in a sale to a strategic
  - The same critical resource
  - Drive negotiation of terms
  - Manage transaction and outside counsel
  - Provide critical insight into target company’s operations, legal matters, capitalization and corporate history
  - Oversee the delivery of material information and documentation
A Primer on Leverage
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- Leverage: Why use it?
- Debt is secured by target company assets (fund never guarantees debt) / pledge of operating company stock and repaid over time by target company cash flow.
- Effect is to supercharge the value of the equity as (1) debt is paid down and (2) target company’s value grows (by acquisitions, improved management, implementation of efficiencies, etc.) over the 3-7 year course of the investment.
- Successful private equity funds can generate returns that well exceed the capital market returns year over year.
Leverage Analysis

- Develop projections to arrive at cash flow available for debt repayment over the investment horizon (typically 3 to 7 years).
- Determine debt capital structure (senior, subordinated, mezzanine, etc.) that results in realistic credit statistics.
- Estimate the multiple at which the sponsor is expected to exit the investment (usually equal to the entry multiple).
- Calculate returns (IRRs) to all stakeholders for a range of leverage and exit multiples.
- Solve for the equity price that can be paid to meet the above parameters.
Total Debt in an LBO

- Typically 3.0x - 6.0x LTM EBITDA
- Interest coverage at least 2.0x LTM EBITDA/first year interest
- Total debt varies by sector, market conditions, and other factors
Senior Debt in an LBO

- Typically 30-50% of capital structure
- Based on asset value as well as cash flow
- Floating rate term loan (with revolving credit for working capital)
- 5-8 year maturity, with accelerated amortization (average life 4-5 years)
- 2.0x - 3.0x LTM EBITDA (varies with industry, ratings, and economic conditions)
- Secured by all assets and pledge of stock of operating company
Sub Debt in a LBO

- Typically 20-30% of capital structure
- Generally unsecured
- Fixed coupon
- May be classified as senior, senior subordinated, or junior subordinated (cash pay vs zero coupon)
- Longer maturity than bank debt (7-10 years, with no amortization and a bullet payment)
Equity in a LBO

- Typically 20-35% of capital structure
- 20-30% IRR on about a 5-year holding period
- Exit multiple = entry multiple
- Employee (including management) options of 5-10%
## Typical Credit Statistics

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Typical Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Debt / EBITDA</td>
<td>4.5x - 5.5x</td>
</tr>
<tr>
<td>Senior Debt / EBITDA</td>
<td>3.0x</td>
</tr>
<tr>
<td>EBITDA / Coverage</td>
<td>&gt; 2.0x</td>
</tr>
<tr>
<td>(EBITDA – CapEx) / Coverage</td>
<td>&gt; 1.6x</td>
</tr>
</tbody>
</table>
Life Under PE Ownership
Life Under PE Ownership

- Generally, little change day-to-day

- PE Fund owners:
  - View ownership as a “partnership” with rollover stockholders and other stakeholders
    - Typically grant nearly all full-time employees incentive equity
  - Do not manage the business day-to-day
  - Serve as strategic advisors through board membership
  - Identify and evaluate add-on acquisition candidates
  - Locate and recruit talent through wide network of industry and business contacts
M&A Activity Increases

- Growth expected to be largely by addition
- Platform companies can expect to complete multiple acquisitions over the course of a fund’s ownership
- “Add-on” acquisition targets may be suppliers, manufacturers, complementary businesses or direct competitors
- Platform company essentially becomes a “strategic” buyer – all cash or cash/stock consideration for 100% of the target
- General Counsel should look to streamline acquisition process both internally and with outside counsel
Life Under PE Ownership

- Leverage Significantly Effects Operations
  - Importance of free cash flow budgeting/forecasting
  - Example of credit/leverage/coverage reporting package
  - Risk of bankruptcy greater than under strategic ownership
Management’s Perspective
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- The Realities of PE Ownership for the Management Team
  - Robust corporate governance regime – board will meet regularly, minutes will be taken and minute book should be kept fastidiously
  - New standards of communication/accuracy/transparency
  - Processes/controls/integrity – “on time, correct, and complete”
Management’s Perspective

The 'Strategic' PE Management Team

- The need to be both adaptable and scaleable
- Operations/Strategy/Cost-Cutting/M&A
- Team building/capital raising/exit readiness
How is the General Counsel Affected?

- Day-to-day responsibilities stay the same
- Governance regime will change
  - Majority of board of directors will be PE fund reps
    - GC should have heightened awareness of conflicts of interest for directors
  - Independent director likely to be added
- Introduction of an operating partner to complement CEO or CFO
- D&O indemnification obligations and insurance will expand
- Relationship with outside counsel can be murky
  - Fund may impose its outside counsel on portfolio company
  - Conflict issues can be waived but still raises ethical concerns
Case Study

- Simultaneous representation of PE fund and portfolio company
- Conflict issues waived but post-closing indemnification issues arise
- Board is split among PE fund and management team because independent director not yet named
- Effective General Counsel leadership can (and should) lead the Board and management team out of morass
Exit Readiness
Exit Readiness

- Simple truth – if bought by a PE buyer you will be sold (or go public) again
- Foremost, maintain (or develop) recordkeeping protocols effective for your business
  - But keep in mind the eventual data request by a new buyer
- Keep clear and up-to-date capitalization records with finance team
Key Takeaways
Key Takeaways

- Be prepared for new corporate governance regime which will be rigidly observed
- Have a heightened awareness for conflicts of interest on board
- Preparation for an increase in acquisition activity should include streamlining the acquisition process internally and with outside counsel
- Key for General Counsel to identify conflicts and insist on distinct outside counsel to PE fund and portfolio company
- Preparedness for an exit