



Vinson&Elkins

Effectively Accessing and Deploying Private Capital

Prepared for ACC

November 2021

Effectively Accessing and Deploying Private Capital

- There is a significant amount of private capital that needs to be put to work.
 - Alternative investment funds have raised \$631 billion in the first half of 2021 and are expected to reach \$1.3 trillion by the end of 2021.
 - Private equity managers worldwide have a total of \$3.3 trillion in dry powder.
 - Buyout, growth and venture funds have posted the largest increases to capital compared to last year.
 - The SPAC boom has added billions of dollars that need to find suitable deals in a relatively short window.

Source: Bain & Co.

Effectively Accessing and Deploying Private Capital

- With so much competition for finite opportunities, private capital is available for more non-traditional investments.
 - Seeding management teams to build new companies or lines of business.
 - Providing growth capital to early-stage companies.

Forms of Investment

- Equity investment in the company.
- Debt financing to the company.
- Hybrid investment (e.g., convertible note or convertible preferred).
- Joint venture/off-balance sheet partnership.

Sizing the Investment

- More is not always better since private capital can be expensive.
 - Equity is dilutive, and a higher investment often comes with more control rights.
 - Debt often needs to earn above 10% given management fees and hurdle owed to private capital's investors.
- If the company is unsure how much capital it will need, the investment can be structured as a drawdown commitment or delayed draw facility.
 - Allows the investor to build exposure as the company grows.
 - Allows the company to pay for capital only when it needs it.
- Because of valuation issues, staging is easier with debt and joint venture/off-balance sheet partnership investments.

Economics

- If the investor is acquiring an equity stake in an existing company, the economics will primarily revolve around valuation.
- If the company is participating in a joint venture/off-balance sheet partnership, the economics may be more complicated.
 - The economics often include a waterfall that returns capital back to the investor plus a preferred return before a promote to the management team.
 - The management team may also receive management fees to cover overhead.
- Debt or hybrid investments (until converted) do not dilute equity but have debt service costs and sit senior to equity in the capital structure.
 - Debt or hybrid investments have an interest rate or coupon that must be paid in cash or in kind. PIK interest compounds the principal amount of the debt. The interest rate is driven by the investor's own cost of capital and its perceived risk of the investment.
 - Some investors offer a lower interest rate but add on a number of fees (like origination, unused commitment, servicing and exit fees) that add to the cost of the debt and may also ask for equity kickers like warrants to boost returns.
 - Companies are often required to collateralize the debt so the creditor can foreclose on and sell the company's assets if there is a default.

Discretion and Oversight Over Deployment

- “No strings” capital is obviously preferable for the company but is usually confined to minority equity investments in existing companies.
- Debt or hybrid investments typically have a “use of proceeds” provision that limits what the capital can be used for.
 - “General corporate purposes” provides the most flexibility.
 - If the investor wants the funds to be used to grow a particular line of business or to make particular investments, the use restriction will be narrower.
- Joint venture/off-balance sheet partnership investments can run the gamut from full discretion subject to certain investment guidelines and restrictions to sign-off from the investor on every single investment.

Governance

- Debt or hybrid investments typically involve limited or no governance rights.
 - Controls over the company are obtained through affirmative and negative covenants. If there is a material breach of any of those covenants, the investor can require full repayment of its debt.
 - Hybrid investments may allow the investor to have a board observer prior to conversion. Once converted, the equity gets to vote for directors or managers alongside other equity.
 - Debt investors that want equity-like controls may ask to appoint directors or managers upon an event of default.
- For equity or joint venture/off-balance sheet partnership investments, the greater the investment, the greater the governance rights.
 - Usually reflected through board seats.
 - May also have block rights over certain decisions.

Exit

- Debt or hybrid investments (until converted) will have a maturity date.
 - Ideally, the tenor should match the company's expectations for ability to repay.
 - In reality, investors are often constrained on how long the debt may remain outstanding, forcing the company to refinance or face foreclosure.

Exit (cont.)

- Equity or joint venture/off-balance sheet partnership investments have a longer hold period, but investors need an exit at some point.
 - With greater governance rights, the company will care who owns those securities, so it should consider restricting transfers.
 - Lock-up periods.
 - Consent rights or prohibited transferees.
 - If transfers are allowed, the investor may want to drag others along in a sale so it can offer the whole company to a buyer. Relatedly, other investors may want to tag along to a sale so they have liquidity if a major investor does.
 - If a company has a management incentive plan, the company should consider how that equity is treated if its private capital exits.
 - If an IPO is a likely exit, the investor will likely ask for registration rights and other related provisions at the outset.
 - The investor may require a forced sale if there has been no exit after a certain amount of time. The company may consider asking for a return threshold in addition to a time threshold so the investor cannot force a sale before the company has had a chance to perform.

V&E Presenter

Emily Stephens

Partner – Mergers & Acquisitions and Private Equity

Los Angeles | +1.213.527.6415 | estephens@velaw.com

Emily is the co-head of our Investment Management practice. She concentrates her practice on all aspects of investment management, including the representation of sponsors and investment managers in the formation and operation of private commingled investment funds, funds-of-one, and separately managed accounts. She has a deep institutional knowledge on the lifecycle of private investment funds from serving for 14 years at Oaktree Capital Management, L.P., a leading global alternative investment management firm, primarily as a Managing Director. In addition to fund formation and operation, she regularly advises on carry and equity arrangements, governance, and subscription facilities. Informed by her prior experience as a member of Oaktree's distressed debt investment team for six years and from serving on almost 15 boards, including those of three public companies, Emily advises clients on how to achieve their business objectives through the use of innovative structures and terms and often assists with investments themselves (including M&A, credit, and restructurings).

