Stradling

Working with Private Equity Firms and their Portfolio Companies

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Agenda

- Overview of private equity
- Drivers of private equity activity and recent developments
- Regulatory developments affecting private equity
- Working with PE backed companies

Private Equity – Alternative Asset for Investors

- Private Equity is considered an “alternative asset”, versus stocks and bonds
- Other types of alternative assets
  - Venture Capital
  - Hedge Funds
  - Real Estate Funds and privately held REITs

- Distinguishing factor is private equity acquires and operates businesses
  - Tax benefits to general partners require three year holding period

Strategic Buyers vs. PE (Strategic)

- Strategic Buyers
  - These buyers operate in the same industry or related one as target (sometimes it can be a supplier/customer looking to expand vertically).
  - Makes purchases based on long-term strategic value.
  - Reasons for acquisition: growth opportunities, increase scale to improve efficiencies, acquisition of talent or IP.
  - Potentially could pay higher multiples due to synergies.
  - As a target - Consider your trade secrets: because these potential buyers are potential competitors, seller to review and consider what proprietary information it releases to buyer (NDAs may not be enough to protect against risk).
  - Consider who the strategic buyer is: Experienced strategic buyers have internal frameworks to accelerate the process of deal execution. Newer strategic buyers may not have the internal resources to complete a transaction as quickly.

Strategic Buyers vs. PE (PE)

- PE Buyers
  - Usually a PE firm has established a fund with committed capital to be used for acquisitions.
  - Capital raised from high net worth individuals and institutions such as pension funds and endowments.
  - Most PE firms will ask existing management to remain in place.
  - PE firms will look at acquisitions in terms of return on capital (looking to improve operations, reduce costs and seek new growth avenues).
  - Usually have defined time-horizons to return capital to investors
  - In order to return capital, the PE firms must exit investments in that time-horizon (IPO, recapitalization and/or sale).

Independent / Fundless Sponsors

- Emerging subset of PE firms.
- No fund/committed capital.
- Sponsors use relationships and connections with capital sources which they approach to raise money when they find deal opportunities (raise money on a deal to deal basis)
- Smaller but more flexible (not constrained by predetermined fund criteria).
- Typically the timeline with an independent sponsor buyout tends to be longer because they must raise capital and conduct due diligence at the same time.

Family Offices

- Another type of buyer.
- Typically have sold successful businesses.
- Taking part of their wealth and investing in privately held companies to diversify family holdings.
- Tend to have a long-term view and have much lower volume of deals than traditional PE Firms.

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Drivers of Private Equity Activity

- Asset allocation by institutional investors
  - Typically expressed as a percentage of invested assets
  - Seeking returns to meet future pension and other obligations
  - Overall growth in stock and bond portfolios when market is strong creates demand for PE/Hedge Funds/Real Estate
    - Because of percentage based allocations by institutional investors
  - Uninvested committed capital = “dry powder”
- Low Interest Rate Environment
  - More debt can be serviced, more is lent, leveraged buyouts proliferate

Why PE Thrived Amid COVID Uncertainty

- Lower interest rates
- Willingness to invest and hold
  - Continuation funds becoming more popular
- Business owners who preferred to sell vs manage through crisis
- Sectors popular with PE did very well in the pandemic
  - Tech/healthcare/logistics in particular

Some trends in PE

- Increased regulatory scrutiny of private markets
- Blurring of strategies
  - PE funds providing growth capital
  - Hedge funds as VC investors or acquirers
  - Non traditional lenders seeking equity investments
  - Family offices proliferating
  - Very long term holdings accepted as an institutional investment category
- Focus on ESG - driven by institutional investors?

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Regulatory Developments in Private Markets

- SEC Rulemaking
  - Disclosure of sources of funding – systemic risk analysis
    - Form PF
  - Enhanced disclosure to investors
  - Limits on indemnification of general partners
- Potential tax changes
  - Limiting capital gains treatment for successful investments
- FTC
  - Revived antitrust scrutiny across all types of transactions
  - Closing loopholes that allowed PE funds to avoid HSR filings
- CFIUS

How Does this Affect Corporate Counsel?

- SEC & FTC rules could “level the playing field” for public and independent private companies
- PE backed companies face additional regulatory burdens
  - Reporting starts to look increasingly like public company requirements
- Transactional due diligence by PE firms will increase attention to reporting infrastructure – both systems and personnel

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Working with PE backed companies

- Making an initial connection
  - PE companies usually operate independently of ownership
  - Some exceptions but typically the PE firm is providing advice and recommendations, not direction to work with certain vendors
  - Understanding the leverage structure/creditworthiness of a PE backed company that is a significant customer
- Financial goals
  - Profitability is more important than revenue
    - Not true in all cases, even for the same company in different contexts
  - Long term relationships are valuable
    - Desire is to show an acquirer of the PE Fund's portfolio company that the value is sustainable

Working with PE backed companies – legal terms

- Contractual terms important to PE backed companies
  - Limited non-assignment clauses, because the PE firm (usually) needs to sell
  - Parent guarantees that need future releases on a company sale are painful for PE firms
    - A guarantee request will sometimes trigger a request of the portfolio company to look for alternatives
  - Limits on liability
  - Flexibility on termination (so as to sell to someone who has an alternative to you)

Stradling Emails

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