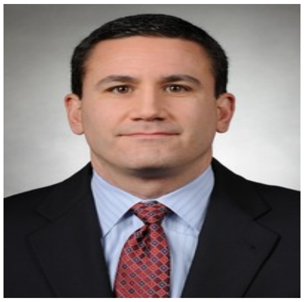

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What Private Equity Buyers Are Doing To Win

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Buyers know that a limited supply of desirable targets, availability of cheap financing and lots of dry powder has made auctions competitive and resulted in high valuations. So the question private equity buyers are asking is: How are other bidders distinguishing their bids from mine? And how can I distinguish my bid from theirs?

Deal professionals know that a buyer that agrees to a tighter purchase agreement with less risk to the seller — both in terms of execution risk and post-closing risk — has an advantage. This article looks at how the market is evolving in the private company context so that private equity buyers know what they are up against and can decide what approach to take.

Execution Risk/Full Equity Backstop

Private equity buyers have traditionally been at a disadvantage compared to strategic buyers, because strategic buyers usually stand behind the full purchase price with their balance sheets. In contrast, a private equity buyer generally makes an acquisition through a newly formed shell entity[1], and the private equity buyer provides this new entity with an equity commitment along with a debt commitment from a third party. In order to signal the buyer's confidence in the financing and reduce the harm to the seller if the deal does not close due to a financing failure, purchase agreements usually provide for a reverse termination fee and, since the newly formed shell entity has no funds, the private equity buyer guaranties the amount of the reverse termination fee. As auctions have become more competitive during the current deal cycle, the trend has been for these reverse termination fees to increase.[2] As a practical matter, at a certain level of reverse termination fee, a buyer will decide to close the transaction if it is financially able — even if that means not having any financing at closing — rather than pay a reverse termination fee, because it is better to pay the "original" price and get the business than pay a high reverse termination fee and have nothing to show for the money.[3] Consequently, the approach of proposing a full equity backstop is a natural extension of the trend toward higher reverse termination fees.

A buyer providing a full equity backstop has improved its bid because the seller does not have to worry about financing risk in the transaction. Some may argue that with debt commitment papers as tight as they are these days — with conditions mirroring those in the purchase agreement — the risk of financing not being available at closing is fairly remote. However, the risk does increase if the debt commitment papers are not as tight as the purchase agreement conditions. Additionally, the volatility of October 2014 does remind us that markets can change quickly, and the perception of risk on a calm day may be different than the reality in choppy waters.

A buyer can also create a timing advantage if it is willing to provide a full equity backstop. Normally, financing is one of the last pieces that determines the timing of closing. If a buyer is willing to fund the full amount of the purchase price as equity (and then obtain financing post-closing if the debt is not ready in time), a buyer can reduce the time between signing and closing. Additionally, by providing a full equity backstop, a buyer may gain leverage over its lenders, because the lenders know that the buyer has a credible alternative of fully funding the deal at closing. So if the lenders do not move at the speed the buyer wants or agree to the terms the buyer wants in the credit agreement, the buyer can fund the deal itself and then shop the debt financing to other lenders after closing.

The recently announced transaction of Vista Equity Partners acquiring TIBCO Software Inc. for $4.2 billion illustrates another situation where using a full equity backstop can be used to a bidder's advantage.[4] Vista was originally making a traditional offer, with a debt financing commitment covering part of the purchase price and an equity commitment covering the remainder. However, the lenders to a competing private equity bidder apparently were offering more favorable financing terms.[5] So, on Friday evening, Vista changed its proposal — Vista would seek new debt financing, but rather than delay the transaction, Vista would provide an equity commitment for the full amount of the purchase price. Vista and TIBCO signed the merger agreement on Saturday. On Sunday, Vista signed new debt financing papers, but the equity commitment did not change and remains for the full purchase price.[6] By agreeing to a full equity commitment, Vista was able to lower its expected financing costs and outmaneuver a competing bidder.[7]

Before a buyer decides to provide a full equity backstop, the buyer should ask two questions. First, what will it cost? This analysis is mainly focused on the time that the asset would be unlevered and the probability that the debt terms could deteriorate or improve. And for those buyers with a captive or affiliated financing arm, the calculation is different because the buyer's affiliate wants to be in that business, although maybe not the same credit risk. Second, does the buyer have the ability to provide a full equity backstop? This answer will turn on the relative size of the deal and the restrictions in the private equity fund documents. As the size of the deal increases, the buyer will be committing a larger amount of capital, and there is only so much money the buyer has, especially if the buyer has tied up capital in other deals with full equity backstops. Even if the buyer has the money, fund documents often limit how much equity a buyer can commit to any one transaction, typically in the range of 15 to 20 percent of the fund. However, fund documents usually also permit additional capital to be used as an equity bridge for an additional 5 to 10 percent of the fund for 12 to 18 months until that commitment can be syndicated to others. Additionally, fund documents often allow the private equity firm to refinance out of a deal in which the buyer funded the entire purchase price with equity and recycle the contributions so long as the refinancing is done within a specified period of time — this recycling provision allows the fund to be put back in the original position it would have been had it originally done the deal with debt. Overall, the more restrictive the fund documents, the less the private equity buyer will be able to engage in full equity backstops.

Post-Closing Risk/No Indemnity

Private equity buyers understand that while all sellers are concerned about their post-closing risk, a private equity seller is particularly focused on post-closing risk because a private equity seller wants to quickly distribute funds to its limited partners to improve its internal rate of return (IRR) and does not want to call capital to make indemnity claims. To limit a seller's exposure, the trend has been for buyers to agree to tighter indemnity packages[8] — characterized by shorter survival periods, higher deductibles and smaller caps — so that the seller would have less money at risk if an indemnity claim is made post-closing. As indemnity packages have become tighter, the next logical step is a no-indemnity transaction, and these types of deals have been appearing in the market. Some buyers may think agreeing to no indemnity is unpalatable, but it is helpful to remember that buyers in public deals do not have the benefit of an indemnity.

No-indemnity deals come in three variations. First, and most common, is the pure no-indemnity transaction in which all the representations and warranties terminate at closing and there are no indemnification provisions in the purchase agreement. Typically, covenants to be performed post-closing would survive, but the purchase agreement would not have any explicit indemnification provision regarding any breach. Second, the no-indemnity deal could provide for no indemnification except for fundamental representations like capitalization and authorization. As fundamental representations are generally not subject to any claim post-closing, the seller does not have much risk of a post-closing claim, yet the buyer can at least obtain comfort for fundamental matters (e.g. that the buyer owns the stock post-closing). Third, the no-indemnity deal could provide for no indemnification except for fundamental representations and certain special indemnities for known issues. The advantage of addressing certain known liabilities is that the parties do not have to agree on the amount of the problem when determining the purchase price but rather only agree upon the allocation of risk. Of course, the seller will have post-closing risk for the amount of the special indemnity.

Besides creating a stronger bid, the buyer benefits because a no-indemnification deal avoids putting the management of the target[9] in an awkward position post-closing with indemnity claims. The tension occurs because management reviewed the representations and warranties and disclosure schedules for the seller and is liable, usually based on its pre-closing ownership percentage, for post-closing claims, but, at the time the claims are made, management works for the buyer and may have some mitigating financial interests depending on managements' post-closing ownership and compensation arrangements.

A buyer can get comfortable with a no-indemnity deal through its diligence, but this can become difficult in certain circumstances (e.g. carveout transactions). A buyer's comfort is also increased if the management team is rolling over a large portion of its equity signaling that the transaction is sound. The buyer can also eliminate its risk by purchasing representations and warranties insurance, and this has become easier and cheaper to do.[10]

Conclusion

With competitive auctions being the norm, bidders need to distinguish themselves. Although price is still the most important deal term, buyers are proposing (or, perhaps more accurately, sellers are extracting) tighter purchase agreements. Two examples are full equity backstops and no indemnification. Depending on the circumstances of the deal and the private equity fund, a buyer needs to think about whether its competition will be taking those positions in their bids and whether the buyer needs to do so.

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[1] This is generally not true for add-on acquisitions. For an add-on acquisition to an existing platform company, the private equity buyer usually structures the transaction as a strategic acquirer would and, for many purposes, the platform company's add-on acquisition is a strategic acquisition.

[2] See 2013 TRANSACTION TERMINATION FEE STUDY 19-22, HOULIHAN LOKEY (2014).

[3] Private equity buyers also do not want to call capital from their limited partners for the purpose of paying a reverse termination fee.

[4] This article is about private transactions, but since more information is available about public deals, a public transaction is used as an example.

[5] See Greg Roumeliotis, Vista Equity Takes Unusual Risks with Private Equity Fund, REUTERS (Nov 11 2014), http://www.reuters.com/assets/print?aid=USKCN0IV0D220141111.

[6] See PROXY OF TIBCO SOFTWARE INC. 34-37 (2014).

[7] See Roumeliotis, supra note 5.

[8] See SUBCOMM. ON MKT. TRENDS OF THE BUS. LAW SECTION MERGERS & ACQUISITIONS COMM., 2013 PRIVATE TARGET MERGERS & ACQUISITIONS DEAL POINTS STUDY 85-109 (2013).

[9] For purposes of this statement, we assume that the buyer keeps the existing management team. This is generally true for a private equity buyer but not always.

[10] A lot has been written about representations and warranties insurance, so that is not repeated here. See, e.g., David Smith and Nicolai Schwarz-Gondek, M&A Reps And Warranties: A Tool For Bridging Gaps, LAW360 (Jan. 30, 2014, 2:57 PM), http://www.law360.com/articles/503988/m-a-reps-and-warranties-a-tool-for-bridging-gaps?article_related_content=1

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