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Minority Investments By Private Equity Funds

Law360, New York (November 05, 2009) -- It's no secret that, while prognosticators may be predicting that a stronger economy is around the corner, the M&A market at most levels continues to suffer and the financial markets remain in a shambles. Many healthy sellers are holding out for a market rebound, and many buyers remain unwilling to meet sellers' pricing demands. Before you think all is lost — there is some private equity capital in the game.

In a typical pre-crisis leveraged buyout transaction, a private equity firm would buy majority control of an existing (and likely mature) business in a highly leveraged transaction, with the goal of obtaining a higher multiple of return by limiting debt funding to a fixed return and thereby maximizing the residual equity value received by the private equity firm on an exit.

The LBO transaction is distinct from the typical venture capital or growth capital investment, in which the venture capital firm invests in a young or emerging company with little or no leverage, rarely obtaining majority control.[1]

Until recently, a true minority investment in an existing or mature company by a typical private equity fund was rare.[2]

With most banks still unwilling to extend credit in an amount or on terms companies are willing to accept, companies need other sources of capital. And with private equity managers sitting on funds that have limited investment lifecycles, private equity is now willing to play where other capital sources are not.

In years past, the typical private equity fund steered clear of minority investments, as many (if not most) private equity managers tended primarily toward control investments. Healthy companies need access to capital as much as they ever did — to refinance existing debt, to pursue acquisition opportunities and to expand operations.

Yet, both mature private companies and private equity funds have limited access to debt capital — which has made the markets ripe for minority investments by private equity funds as a bridge between these market players. While private equity is now willing to play in this space, on what terms should the private company expect?[3]

At first glance, the terms in a private equity fund minority investment and venture capital minority investment are very similar.

Both will likely demand that the minority investment take the form of preferred equity with typical characteristics, such as a liquidation preference and often even a dividend preference over the common and other classes of junior preferred equity; provisions requiring mandatory payment in full (plus accrued and unpaid yield) upon a sale of the company or an initial public offering; a conversion feature into common (and possibly also participation with the common); anti-dilution protections; and piggyback and possibly post-IPO demand registration rights.

The similarities, however, stop there.

To understand why private equity funds will demand additional terms when they invest in an existing or mature private company, you must first understand that private equity funds are sophisticated investment vehicles that desire to control the timing of the liquidation of their investment and maximize returns when market and business conditions are optimal.

To do so, PE firms want to manage the entire investment timeline — from initial investment to liquidation of its position. While the private equity firm is unlikely to impose arbitrary liquidity deadlines, it does have to answer to its limited partners and they typically seek liquidity events on investments within a five- to seven-year time horizon.

While venture capital funds are also sophisticated investment vehicles, they have historically been more willing to make minority investments with the hope that a few "home runs" will provide sufficient returns on all of their invested capital.

Accordingly, venture capital firms have not historically demanded the same level of control in their investments as those made by typical private equity funds.

In addition, given the historical dearth of private equity investment in the minority investment space, there are not as many "market norms" governing minority private equity investments as there are for more traditional minority venture capital investments.

The minority investment terms that a private equity fund will demand and expect to obtain from a private company vary significantly from the "alphabet" round of preferred stock financing that venture capital firms provide to start-ups and other growth companies. The VC firm may ask for many of these same provisions, but will often be willing to make a minority investment without them.

Key terms for a minority investment by a private equity fund in an existing or mature private company include:

Significant Control Over Key Business Decisions

While the private equity fund will typically not seek board control, the fund will put significant veto rights in place, essentially obligating the company to seek the fund's consent to all or almost all material events. Veto rights are commonly negotiated to prevent the following without the fund's consent:

- issuance of new equity (possible exceptions may be allowed if preemptive rights are also provided to the fund)

- debt incurrence in excess of a specified amount
- sale of the company or change of control transactions
- acquisitions or dispositions of assets or sale-leasebacks outside of the ordinary course
- entering into a new line of business

- capital expenditures in excess of a specified amount or other than set forth in an agreed-upon budget

- adopting or entering into management incentive arrangements or employment agreements with senior management

- other transactions with management or transactions with affiliates
- changes to organizational documents (to protect investment terms)
- changes in board size or composition

- adoption of, or material changes to, financial budgets or failure to meet certain key financial performance metrics

- termination of and/or selection of CEO/CFO

These veto rights are not typically found in venture capital "start-up" investments. Further, these are rights held by the fund.

While a director may be designated to sit on a board of directors (if a corporation) or board of managers (if a limited liability company) at the direction of the fund, that director must exercise his fiduciary duties when deciding whether to cause the company to pursue any of these material events. A fund, as an equity holder, typically has no such duties (unless written into organizational documents — which would be unusual).

Thus, a fund may choose to veto a company's short- or long-term plans in any of these key areas (typically with the goal of maximizing the return on the fund's investment) whether or not it might be deemed in the overall best interests of the company to do so.

Significant Control Over Exit

In a typical control investment, the private equity fund makes the sole determination of how long to hold on to its investment. At any point in time, the fund is determining whether to hold its investment (with the hope of making greater returns in the future) or whether to liquidate its investment and take its cash now.

In a minority investment, the fund will often attempt to have that same level of control through a variety of means. These exit control rights are also not typically found in venture capital "start-up" minority investments.

Put Right

One of the most important terms in any minority investment is the fund's "put" right. The fund will typically demand the ability to force an exit. This forced exit (or "put") can come in any number of flavors.

There may be a hard and fast date (typically two to five years from the original investment date) after which the fund can liquidate its investment — by demanding that the company pay on its initial investment (plus some guaranteed rate of return).

In some instruments, the fund may exercise its put right even earlier in the investment so long as all or certain designated holders make an agreed-upon return on their investment (e.g., 2x or more).

Or there may be specified events that allow the fund to cause a put — failure to meet certain financial performance metrics or resignation or loss of key personnel.

Historically, it was common for put provisions to have little in the way of "teeth" — the fund might enjoy an increased "default" rate of interest on its investment or an additional director if the company defaulted on the put obligation but the fund couldn't actually cause the sale of the company that would enable the fund to realize on its investment.

More recently, funds are demanding more "teeth" in their put provisions. For example, if the company is unable to pay the fund its liquidation preference within a short period of time following notice of the put, the fund may have the ability to take control of the board.

In addition, the fund may have negotiated for the ability to control the sales process and force a sale of the company — by hiring its own bankers and obtaining drag along rights or other power of attorney rights to cause the sale.

In the end, the company with a private equity fund investor should be prepared to be put "on the block" to satisfy obligations to that minority investor (in the event it doesn't have sufficient cash flow to meet the put obligation or access to debt capital to finance the obligation).

The company and its other investors may find that there is a new owner of the company in several years — without any input over the identity of that owner or the terms of its ownership investment.

Forced IPO

While a VC fund may have some sort of registration rights as part of its minority "startup" investment, it may not have the ability acting alone to force an IPO.

When a private equity fund makes a minority investment, particularly in a larger company that is likely able to support a meaningful public float, the fund will often demand the right to cause an IPO of the company after a specified period of time (e.g., two to five years).

Through the IPO, the fund may require the company to use a portion of its IPO proceeds to redeem the fund's investment and/or the fund may sell some or all of its investment in that offering or follow-on public offerings.

The company that agrees to a forced IPO provision should be prepared to go public and thereafter to be governed by the strict rules and regulations of Sarbanes-Oxley Act of 2002 and other U.S. Securities and Exchange Commission regulations, including the obligations to file public periodic reports.

Conclusion

Currently, healthy companies have limited access to capital markets. At the same time, private equity funds have capital that needs to be put to work. Funds have few control investment opportunities to use that capital in a market with limited LBO and financing alternatives. Healthy companies should be aware that private equity funds are now willing to make minority investments.

While your private equity fund investor will likely have considerable control over both your ongoing operations and your ultimate destiny, your new capital partner will also bring considerable managerial, financial, technical and industry expertise to the table to drive you through the current crisis.

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The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Since the typical venture capital investment in a young or emerging company involves no debt capital, venture capital funds continue to make minority investments in the current economy.

[2] Private equity firms have historically been willing to join together to do a "club deal" — where each firm may have a minority investment, but together all firms have a control position. This article does not address these deals where the private equity funds collectively have control.

[3] Private equity firms have also been willing to make PIPE investments (private investment in public equity). This article is focused on private investments in private companies and does not address PIPE deals.