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Business Knowledge Private Equity buyers play it safe

The impact of private equity led acquisitions is increasingly being felt in New Zealand corporate sale and purchase transactions. Shelley Cave and Michael Pollard set out how financial (private equity) buyers seek to get deal protection with a view to avoiding losing deals to other buyers.

This article was first published in the Australasian Legal Business Magazine and was written by Shelley Cave, Partner and Michael Pollard, Senior Associate.

The key ways in which financial buyers seek to mitigate deal risk are by gaining exclusivity, putting in place break fee arrangements and gaining management inside track.

The November 2004 issue of *The Economist* describes the private equity industry as "capitalism's new kings", citing statistics such as a 60% increase in references to the term "private equity" in the *Wall Street Journal*, *New York Times* and *Financial Times* in two years. A financial buyer is usually a private equity sponsored investment vehicle which finances its investment portfolio using a mixture of debt finance from third party lenders (usually banks) and equity finance.

The New Zealand experience mirrors the international trend: according to the New Zealand Venture Capital Monitor half year report to June 2004 published by Ernst & Young, investment in the first half of 2004 was \$77.7 million, 89% of the entire amount invested in 2003. Committed capital available to NZ private equity and venture capital funds was approximately NZ\$1.512bn, with NZ\$685m available for investment. Australian private equity funds with access to pools of committed capital are also very active in New Zealand markets.

Whilst recognising that competitive tension is a normal part of any well run sale process, it is worth noting the financial buyer's sensitivities to deal risk and the means by which this risk is sought to be mitigated. Deal risk sensitivities are heightened for financial buyers for the following reasons:

- First, financial buyers seek to get their fund under investment as soon as reasonably possible. The fund's overall return is prejudiced during any time that part of the fund is not invested. This overall return is used to benchmark one fund's performance against another's and is an important factor in a fund's ability to raise further capital. Financial buyers tend to have relatively small deal teams and it is unattractive for these teams to spend significant time and effort pursuing an investment opportunity to then lose it to another bidder; and
- Second, acquisitions are seldom strategic and financial buyers do not have existing businesses against which they can write off the costs of a failed acquisition. Having regard to the number of investment opportunities investigated, they are sensitive

to the need to ask their advisers to regularly share their pain.

The key ways in which financial buyers seek to mitigate deal risk are by gaining exclusivity, putting in place break fee arrangements (where the financial buyer is compensated by the payment of a set fee, typically if it misses out to another buyer), and getting management inside track.

Exclusivity is a fairly typical objective for any private equity or trade purchaser. To a lesser extent, the same applies to break fee protection, however recent overseas experience in particular has seen a rapid increase in the frequency of break fee arrangements in private sale transactions driven by financial buyers. It is increasingly common to see financial buyers being paid "work fees" to keep them in an auction process on a "no risk" basis for the financial buyer and, from the seller's perspective, with a view to keeping competitive tension and ultimately securing a better price.

A distinction with the trade buyer arises when it comes to the financial buyers stance on management inside track. Most financial buyers don't seek to introduce their own management teams following investment. In fact, most have fairly limited headcount and don't seek to provide day-to-day support or interface. The management team is ordinarily a blend of the existing senior management of the target and, where required, new outside management for key positions. Instead, financial buyers seek to profit from the transaction by selecting quality management and equating the incentives of the management team with their own interests. This creates a community of interest which assists to put the deal together, to manage the investment going forward and to create value which can be extracted on exit.

Incentivisation is ordinarily achieved through issuing management with options or providing a conversion mechanism applicable to the equity in the company in which the investment was made. This provides management with a relatively greater stake depending on the exit multiple. This incentivisation package can put target management in the financial buyer's court during sale negotiations and does create some conflict of interest since management is the only reliable source of information about the target business for both the seller and the financial buyer. It also gives rise to issues in auction situations where prospective purchasers may be put off by seeing management favouring a particular bidder. It is critical for any seller to manage this process carefully, recognising that restricting the financial buyer's access to management may make it very difficult for the financial buyer to progress the transaction, therefore undermining their ability to pay full price, and the attraction of having the financial buyer in the process to provide competitive tension.

This update is part of a longer article on doing business with financial buyers explaining their key drivers in implementing any transactions. To obtain the full article go to www.simpsongrierson.com or contact Michael Pollard.



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