

# JUDGMENT CALL

## Self-help takes shape in PE buyout world

*Flexible techniques can make the difference in a challenging credit environment*

BY ADAM R. MOSES

There has been no shortage of nearly histrionic coverage in the financial press of the demise of the golden age of private equity occasioned by the prevailing weakness in the global credit markets. That the once indomitable PE juggernaut, which was arguably the chief author of the 2004-2007 M&A boom, has faltered presents a compelling storyline.

However, a related, though less dramatic, tale also deserving of attention is how financial buyers, responding to diminished credit availability and the resurgent clout of strategic acquirers, are deviating from the highly leveraged, all-cash buyout template that prevailed during the boom period to get deals done.

Making use of flexible forms of deal consideration, financial buyers appear to be increasingly incorporating earnouts and seller financing into the consideration they offer targets to boost the “headline value” of their bids and reduce the amount of acquisition consideration required to be financed by third parties to close deals. In addition, PE buyers are employing a broad range of flexible investment strategies, which are also designed to lessen the need for up-front third-party acquisition financing. Such strategies include the purchase of minority equity positions in targets and requesting that sellers roll over significant stakes in targets.

The use by PE purchasers of earnouts both limits their funding obligations at closing—and thus dependence on third-party financing—and reduces their exposure to future operational uncertainties at target companies. Although the terms of earnouts can vary considerably, under one common earnout arrangement a portion of the purchase price for a private company is deferred and made contingent upon the attainment by the acquired company of financial performance benchmarks at one or more specified intervals following the completion of the acquisition. In such an arrangement, the buyer and seller share a measure of the risk of the target’s future financial performance, with the buyer paying an increased purchase price only if the target achieves agreed-upon financial milestones.

From the financial buyer’s perspective, earnouts also have the salutary quality of providing selling stockholders who remain in management positions following the acquisition with a powerful incentive to drive strong results at the acquired business. Since PE purchasers often depend on the contin-



ued effective service of existing owner-managers following acquisitions, this can be an important advantage. In exchange for these benefits, financial buyers often must offer more total potential consideration—measured to include the assumed payment of the earnout—than would a purchaser offering to pay in cash at closing.

The May agreement of **Kohlberg Kravis Roberts & Co.** to acquire Oriental Brewery, **Anheuser-Busch InBev NV**’s South Korean brewery, for \$1.8 billion featured an earnout provision enabling Anheuser-Busch InBev to participate in Oriental’s future economic performance. Similarly, **Filtrona plc**’s April sale of **Filtrona Extrusion Inc.**, a manufacturer of plastic products, to PE firm **Saw Mill Capital LLC** featured an earnout—the payment of which is contingent on the sold subsidiary’s 2009 and 2010 Ebitda performance—representing up to about 26% of the total consideration payable in the deal.

Seller financing, another flexible form of purchase consideration, has also figured in a number of acquisitions completed recently by financial buyers. In a deal involving seller financing, a seller is asked to participate directly in the financing of the transaction by agreeing to accept a debt security or promissory note (sometimes referred to as “seller paper”) issued by the target as one component of the total purchase consideration it receives in the transaction.

For instance, under the terms of Anheuser-Busch InBev’s sale of Oriental to KKR, Anheuser-Busch InBev will take seller paper in payment of \$300 million of the \$1.8 billion price tag, representing nearly 17% of the announced purchase consideration. Filtrona’s sale of the unit to Saw Mill also contained a seller financing component in the form of a five-year note representing roughly 9% of the total consideration payable at closing. In September 2008, PE firm **Water Street Healthcare Partners LLC** acquired a controlling stake in **CareCentrix**, a unit of **Gentiva Health Services Inc.**, in a transaction valued at \$147 million, with \$25 million of the transaction value represented by an interest-bearing seller note.

Using seller financing enables a PE buyer to shift to the seller a portion of the financing that it may otherwise be required to obtain from third-party lenders or the capital markets. In

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exchange for financing a portion of the sale consideration, a seller may expect seller paper featuring an attractive rate of interest or may demand a higher aggregate purchase price for its business than it otherwise would have required.

Invariably, the terms of seller paper are carefully negotiated. However, in transactions in which the target has significant debt that will remain after closing or in deals in which third-party acquisition financing will be obtained, it isn't uncommon for interest payments on the seller paper to be permitted to be made—if at all—only in circumscribed circumstances or only in-kind, and for the debt itself to be unsecured, nonamortizing, subordinated to much or all of the target's other debt and issued without significant restrictive covenants protecting it. Such terms often enable the target to incur and service the debt represented by the seller paper in compliance with the restrictive covenants that may be contained in its existing debt documentation and facilitate the successful marketing of acquisition financing to prospective third-party lenders by offering them a comparatively privileged position in the target's capital structure and reducing the extent to which the seller paper imposes short-term liquidity pressure on the target. Sellers in such transactions will frequently press for an interest rate—even if interest will not be payable in cash in the near term—that compensates them for the seller paper's compromised position in the capital stack and the limited contractual protections it enjoys.

They may also seek the right to require that the seller paper be redeemed when specified trigger events occur, such as a change of control at the target, a substantial equity sale by the PE sponsor or a refinancing of other debt at the target.

By contrast, in deals in which there is no material continuing debt at the target and no third-party acquisition financing or in transactions in which the seller financing amounts to a considerable portion of the total purchase price, the seller paper may be structured to afford sellers a broader suite of protections, such as cross-acceleration provisions, restrictive covenants, seniority in right of payment and collateral support.

As an alternative, flexible strategy for putting their clients' money to work, financial buyers have turned to purchases of minority stakes in targets. Naturally, when compared with the acquisition of all of the equity interests in a target company,



a minority position investment lessens the reliance of purchasers on external financing by reducing the size of the investment made. These investments may also offer funds the opportunity to achieve exposure to promising companies that are not receptive to change-of-control transactions. In exchange for their minority investments, PE firms often insist on obtaining some measure of influence over the affairs of targets, such as board and committee representation, pre-emptive rights with respect to future equity issuances and management consultation rights.

For targets, minority investments by financial buyers can represent an efficient and expeditious alternative means of raising capital. These transactions also enable investees to avail themselves of the additional financial and operational expertise sophisticated buyout shops can provide.

PE firms make minority investments in public companies largely through private investment in public equity, or PIPE, transactions. In PIPE transactions financial buyers often purchase in a private placement at a discount a substantial position in the common stock of a target or other securities, such as preferred stock or bonds, of a target convertible into its common stock. The purchased securities commonly enjoy registration rights to ensure that PE firms can achieve an orderly exit in the future should they choose to reduce or dispose of their investments through the capital markets.

Recent examples of PE minority stake purchases include KKR's June \$350 million investment in **East Resources Inc.**, a privately held natural gas exploration and development concern. KKR's investment was made in exchange for debt convertible into a substantial minority stake in East Resources. In a June PIPE deal, PE fund **BC Partners** made a \$350 million investment in struggling retailer **Office Depot Inc.** in exchange for three board seats and preferred shares of the company convertible into at least 20% of its common stock. **Olotoa Investments Inc.** agreed in a March PIPE transaction to buy 49% of **ChinaTel Group Inc.**'s Class A common stock for \$300 million and also snagged a board seat.

Another investment technique finding use in the hands of debt-starved financial buyers involves purchasing a controlling stake in a target and insisting that sellers indirectly participate

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in the financing of the acquisition by either rolling over or continuing to hold a significant portion of their equity. In these investments, rather than acquiring all or nearly all of a target's stock, PE firms effectively buy a majority position, frequently amounting to 55%-75%, of the target's equity, and the sellers continue to hold the remaining equity in the company after the transaction.

For a financial buyer, this approach can significantly reduce the cost of an investment and the corresponding need for financing, while still affording it substantial control over the governance and operations of a target and the ability to exit in the future on its own terms. In addition, a majority stake investment powerfully aligns the interests of the financial buyer and those sellers who retain equity stakes, encouraging all equity holders to strive to achieve strong financial results for the company. For seller-managers seeking a liquidity event, a financial partner, and continued participation in the management and potential upside of a target's business, a majority stake investment by a financial buyer can prove very attractive.

Recent transactions using this approach include **Morgan**

**Stanley Private Equity's** June investment in **Triana Energy Investments LLC**, a natural gas exploration and production business. In a deal announced in June, **TPG Capital** and **Riverwood Capital LLC** agreed to acquire a 65% stake in privately held **Aptina Imaging Corp.**, an imaging solutions business, from **Micron Technology Inc.**

Facing a dearth of credit, many PE firms that rode high during the boom period have adapted to the new realities of the market by sometimes departing from the highly leveraged, all-cash buyout model. In opting for alternatives, financial acquirers have cast aside the old bromides about how they should invest and have demonstrated that a nimble, creative approach to investing will be rewarded in the present market.

While the balance of buyout power will not shift from strategic acquirers back to financial buyers anytime soon, PE firms that employ flexible deal structuring techniques to seize promising investments are likely to hold their own in the challenging post-bubble dealmaking environment. ■

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