INSIDE THE MINDS

Private Equity and Venture Capital Trends in a Turbulent Economy

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Private Equity Trends During the Credit Crunch

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The Credit Crunch

We are currently in the middle of a major economic downturn, as well as a turbulent economy. This is best evidenced by the high volatility in the market. We see swings of hundreds of points on all of the major indexes, and while the general trend is down, there is significant volatility involved. We are seeing deflation in the consumer price index. We are seeing increasing unemployment rates, and an increase in bankruptcy rates throughout all industries, which is especially visible in the financial services industry. We are also seeing a lack of consumer and investor confidence. Fewer investment deals are taking place. There is a marked decrease in consumer spending. The economy is causing a complete lack of predictability of anything from stock prices to commodity prices to futures of specific companies.

The warning signs of a downturn or a slowdown in the economy depend on the cycle and vary with the reasons underlying the particular crisis or economic downturn. In the present case, the decrease in availability of liquidity was our first public warning sign. It hit relatively suddenly. Everything was great up until July 2007. We were very much in a bull market; the leveraged buy-out levels were at an all-time high; there was tremendous liquidity; deals were getting done; loans were being made; auctions were unbelievably competitive.

Then in July came what is known as "the credit crunch."

For the roots of this, we would have to go back to the "happy days" of 2004 to 2007. The economy was doing great. There was excess liquidity in the markets, and as a result, the banks were looking to lend. The lending model was also changing—many loans were no longer held by the initiating bank, but instead were being syndicated and taken "off the books." That practice changed the acceptable risk profile of a loan to the lending bank. Coupled with high asset valuations and lack of transparency in the market because of the increasingly complex structured financial products, this led to overleveraged deals, loans extended to borrowers who could not afford them, and "covenant lite" loans.

The bulk of the "bad" loans were the sub-prime mortgages. In the summer of 2007, a number of banks began to realize that there was a tremendous amount of bad debt on their books that they would not be able to syndicate as they had planned, and they stopped lending.

That is a somewhat simplified explanation of what caused this economic downturn. Many industry experts believe that the credit crunch was caused by things deeper than the sub-prime meltdown, and that the sub-prime crisis and the resulting credit crunch are the effect rather than the cause. The market has gotten extremely complex. Complex structured transactions were taking place; investors were buying securities they did not understand; and there was a lack of transparency in the market. Nobody knew, and still nobody knows, how much debt is out there, how the debt is bundled, or what the various obligations look like. Typically, when a company goes bankrupt, its debt amounts are readily available. It has been several months since the Lehman bankruptcy, and it is still not clear what its outstanding debt obligations are.

There is a lot of discussion about what the industry and the government should do to reverse this downward trend. One thing the financial services industry can do to curb this trend is try to self-regulate; prepare to be somewhat more transparent; and create an exchange for the complex debt products so the transactions can be quantified. This is a sensitive subject, as it is hard to get any industry to self-regulate. I believe that to the extent that can be accomplished, industry self-regulation is more efficient than a government regulating an industry, as it allows for regulation without the loss of a competitive advantage and without impossible burdens.

In my view, the governments' role in the reversal of this crisis should be somewhat limited. While there will be an attempt to do so, I am not sure the government is in the position to effectively regulate complex financial industries. Much of what is going on in these industries is very much free market-driven, and excessive regulation could not only make it extremely costly for the industry to operate, but at the extreme could actually kill the industry. The financial industry is built on the free market dynamic, and that is what gives it a competitive advantage. Over-regulating it does not necessarily go in the right direction. Take for example hedge funds: a hedge fund that is regulated into transparency and required to publish its investment strategy might as well not operate, because if the fund is successful, everyone can follow the strategy. The fund then loses its advantage and profit margin.

The government absolutely needs to play a role in economic recovery, but not through excessive regulation. In this economy, the government providing liquidity at critical times is important, but I think how the liquidity is used should be dictated a bit more by the market—who can use it best and profit from it the most—rather than having the government decide which businesses are crucial.

Private Equity Trends after the Credit Crunch

One misconception about the current state of private equity or venture capital is that the industry is at a standstill and has no role in this economy. That is just not true. Deals, while they are very different from what we saw a couple of years ago, do get done. That is especially true in the middle market. Another, potentially bigger, misconception is that a leveraged buyout deal actually contributes to a turbulent economy. While there may have been some over-leveraged deals that were a product of their times, as a rule, I think it is the opposite.

The availability of private equity money to do deals will eventually become a major factor in reversing the cycle of this economy. That money will be used to buy the undervalued assets and increase their valuations, and that will help provide liquidity to the market. The private equity sponsors will be instrumental in restructuring companies that need more efficient management, combining companies with synergies, and breaking up the assets that should not be together in a conglomerate. One of the things the private equity managers are really good at is making the companies more efficient and positioning them to grow.

While the private equity industry is not at a standstill, the leveraged buyouts require "leverage" or debt financing, so the industry is obviously significantly affected by the credit crunch. The most prevalent trend in the industry right now is the slowdown of deals and the reduction in deal size. The rate of announced leverage buyout transactions from private equity firms has dropped 70 percent from September 2007 to October 2008.

Global buyout activity is currently at a four-year low, and global deal value declined from $738 billion in 2007 to $212 billion in 2008. Deals are announced and completed, but the overall deal value is down, and the individual deal size is down, as well. Before the credit crunch hit, we were seeing mega deals. In 2007, forty-six deals were announced with a value more than $1 billion each, and four of them were worth more than $10 billion. In the first half of 2008, only nine deals over $1 billion were announced, and they were all under the $10 billion range. Currently the largest sized deals are in the $2 to $5 billion range, so they have gotten significantly smaller. The ratio of debt to equity in these deals has also changed, and significantly more equity is now required.

Other parallel trends in the industry include a slow-down in the fund-raising and decline in exits and distributions.

I think another trend that will become more pronounced in the near future is the change in certain fundamental terms of the private equity deals.

To explain this, a little history would be helpful. I started practicing in the private equity industry in 1998, right after the financial default in Russia. This was not a great time in the markets for sellers, and private equity buyers had significant leverage when negotiating deal terms. At the time, it was common practice for private equity funds to not enter into acquisition agreements directly, but instead to form shell acquisition vehicles (companies with no assets of their own, owned by the private equity fund) that entered into the acquisition agreement. The fund itself did not guarantee the obligations of the acquisition vehicle under the acquisition agreement. The seller was essentially entering into an agreement with a company with no assets, relying on the reputation of the private equity buyer—the assurance by the private equity buyer that the fund would not be able to do future deals if it backed out of a deal for no reason. While this statement is true and carries a lot of weight in the industry, it is still not nearly as good from the seller's perspective as an actual guarantee.

The acquisition vehicle would enter into an acquisition agreement with the seller, and the acquisition agreement contained a "financing out." The "financing out" is a provision that allows the acquirer to back out of the deal if the senior debt financing, or whatever the appropriate debt financing component was for the deal, became unavailable. At the time of the signing of the acquisition agreement, all that the acquisition vehicle had was a set of signed commitment papers from the bank saying, "We will fund this deal if all the conditions are satisfied," and the conditions included material adverse effect in the market, material adverse affect on the company, due diligence, and other standard conditions. Therefore, when the private equity fund entered into an acquisition agreement for a transaction, the fund was not fully committed if the financing became unavailable. The fund would close the deal if the deal still made sense and financing on satisfactory terms were available for it. But if there was a downturn in the market, or something happened at the company, the private equity fund could back out of the agreement, saying, "My lenders are pulling out; the conditions in their commitment letters are not satisfied; and I am not obligated to close."

As we fast-forward to 2006, we end up in a true seller's market. The private equity funds had tremendous amounts of liquidity. They needed to invest the funds, and the financing was readily available. We saw fierce competition for just about every asset on the market. The private equity firms were not only competing with other funds, but they were competing with many strategic buyers with cash on their balance sheets that did not need financing to close the same deals. This resulted in significant changes in deal terms for private equity buyers.

In 2005, we started seeing deals without financing conditions, where the private equity firms were obligated to close deals regardless of whether the committed financing was available. In addition, the private equity funds started guaranteeing the obligations of the acquisition vehicles under the acquisition agreement. This was a big change for the private equity buyers. A private equity firm cannot do a deal without financing, but it had direct obligations to acquire an asset regardless of whether the financing is available. If the banks refused to finance a deal, the private equity fund was still "on the hook"; it was obligated to close the transaction.

I will always remember the first time I represented a client who signed a deal without a financing out, representing a private equity firm. I had many sleepless nights, worrying about the "what ifs." The reality of the situation was that the financial buyers had to enter into these deals without financing outs to successfully compete with strategic buyers, as well as other private equity firms. These were also the times when financing was generally available, so the risk to the funds was relatively low. In addition, the deals started to include several mechanisms to limit the exposure of the private equity buyers if financing became unavailable. One is commonly referred to as a "reverse break-up fee." The fund would agree with the seller that if they are unable to close the deal because they cannot get financing or for another reason out of the seller's control, the fund would pay the seller a set break-up fee. These fees were fairly significant; they were typically in the range of 3 percent to 5 percent of the purchase price, but we saw some that were in the 10 percent range for smaller deals. So the private equity buyers could be obligated to pay a significant portion of their fund into a deal that did not close. The occurrence of this would not make limited partners in the fund very happy, but it was still better than being obligated to close a deal when a financing was not available. (See Appendices A and B for sample financing condition and reverse break-up fee provision.)

At the same time, the banks, pressured by the market, started to agree to remove various conditions from their commitment letters and to align the conditions in the commitment letters with the conditions in the acquisition agreement. That minimized the risk to the private equity funds that a bank would pull out of deal.

That was the state of the deal terms at the height of the competitive leveraged buyout market. There were billions of dollars of executed deals in the market with fully committed financing, no financing outs for the buyers, and no real outs for the banks. It was then that we went right into the credit crunch. A number of banks were simply unable to fund their committed deals, causing the private equity buyers to become liable to pay the "reverse break-up" fees. Most of those deals were restructured on terms more favorable to the buyers, but others were not and ended up in disputes.

In this new economic situation I believe we will start to see a return to the deal terms we saw earlier, when the markets were more favorable to the buyers. I think we will see, if we are not already seeing, a return to financing conditions as a standard term of the deals. I do not think many funds will be willing to enter into deals without financing outs in the current environment. I think we will also see, and we are already seeing, bank commitment papers getting back to the pre-LBO boom era, and including conditions that are far broader than those contained in the acquisition agreement (including material adverse effect in the marketplace and specific conditions with respect to the target company).

I do not know whether the reverse break-up fees will be here to stay. My prediction is the reverse break-up fees would be harder to get out of the acquisition agreement than any other deal term. Maybe we will see something like dual reverse break-up fees. If the financing condition is not satisfied and the deal does not close for that reason, the fee would be smaller. If the condition is satisfied and the fund pulls out anyway, the fee would be larger.

Interestingly, there is a lag in the change of these deal terms. I would have expected to see the change right after the credit crunch began. I did a survey of deal terms of some public transactions in January of 2008, and we were not seeing a return of the financing out yet. I think this is largely because there is a typical lag between the onset of a downturn in the economy and the reactions of various industries. In my practice, we are definitely seeing a return to the more pre-LBO boom levels of protection for private equity funds, and I think that will be the trend.

Overall, I think the private equity model is a good model, and it is here to stay. The private equity industry provides liquidity to the selling companies or the public shareholders. It leverages the target, and when done correctly, this allows the company to operate more efficiently. The restructuring provided by the private equity managers positions companies well for growth and success. Putting aside the LBO boom over-leveraging and credit crisis, I think the companies that have been bought out by the private equity industry have done very well. They grow significantly and are usually sold at much higher valuations several years down the road.

As everybody takes a deep breath and realizes this is not the end of the world and life will go on, as liquidity becomes more available, many funds will try to take advantage of the low asset valuations. I think we will see an increase in the leveraged buyout activity as buyers take advantage of that. Overall, as I said, I think the private equity model is a long-term trend that is here to stay.

International Trends

Our economy and our markets have become so global and internationally intertwined that almost everything happening in the United States is echoed internationally, and nearly simultaneously. When the credit crunch began here, it quickly spread to Europe. The banks that hold the bad assets do business heavily in Western Europe and in many developing countries, as well.

Most non-U.S. banks, even the ones that were not involved specifically in the U.S. markets and did not have the "bad" loans, still have significant exposure to U.S. markets. They trade heavily with the U.S. banks and otherwise have business relationships with the banks that have gotten into trouble in the United States, so they are still affected. I cannot tell you which countries or banks would be able to escape the effects of this economy. Some countries will do better than others, but any country that is a player in the global market will be affected by this. The international scope of this economic downturn is unprecedented.

As every country is affected, the lack of liquidity in the United States will equally affect clients with international ties. The typical financing sources for overseas companies are the same banks that have been providing liquidity to U.S. markets, so bank financing in the rest of the world is equally difficult to obtain.

Overall, at this point, the fact that a company is internationally diversified does not really ease the burden of the economic crisis on that company. The difference in currency prices that was encouraging European investment in the United States is almost erased. When the dollar was low against the Euro, companies with significant European operation were able to acquire assets in the United States at very favorable valuations, using financial sources from their European operations. That is changing now as the weaknesses in European economy are causing the dollar to rise against the Euro. While this is generally helpful for the United States economy, it discourages European investments in the United States.

Alternative Strategies in the Credit Crunch

Whether a company has international ties or not, there are certain steps it can take to preserve its operations during this difficult period in the economy and to continue growth. The most basic step is cutting non-essential costs. We are seeing that frequently—companies cutting non-essential legal work, getting rid of non-essential vendors, canceling their annual holiday galas, and the like. Many companies discontinue certain research and development projects that otherwise would have fueled a company's long-term growth. Instead, companies use those funds to continue to finance regular operations, putting the long-term growth projects on hold for the moment.

If cost-cutting is not enough, companies can try other strategies to survive the troubled times. One is a sale of non-essential assets or divisions. The problem with selling in this economy is that the valuations for sold assets are extremely low. Nonetheless, if a company needs cash to finance its core operations, this can be a potential solution.

Companies can also try to raise funds from third-party financing sources. While traditional senior debt lending is very difficult to obtain, there are some alternative financing sources available. Hedge funds, wealthy individuals, and similar sources are providing some of the alternative financing. Many of these sources have liquidity and are entering into non-traditional financing arrangements, such as convertible debt with warrants, monetizing a revenue stream for a particular product, and others. Monetization of a product revenue stream, for example, is relatively common in the pharmaceutical industry, where you can monetize the projected revenue stream of a particular drug, get that money up front in the financing, and use it to finance the development of a different product. Obviously, the downside of these financing arrangements is that the terms are typically unfavorable to a borrower. The interest rates are high; conversions to equity are on difficult terms; warrants are for a significant percentage of the equity. But that financing is an available alternative.

Another alternative, which is somewhat similar to non-traditional financing, is to enter into joint venture-type arrangements, where a financing source would be financing the operations of a company in exchange for equity in the company or an agreed-on revenue stream in the future. This is a financing of sorts, but also non-traditional. The company can also sell its equity interests and obtain a capital infusion that way, but it has to be careful to retain the desired control. Finally, an entire company can be sold to a strategic buyer with better funds or to a private equity fund. The original owners can maintain a portion of the equity and enter into a management arrangement.

Legal Practice and the Credit Crunch

This economy has significantly affected my clients and as a result significantly affected my legal practice. My practice is generally a transactional mergers and acquisition practice, with a heavy emphasis on leveraged buyouts. We are seeing fewer and smaller deals deals. There is a lot of "wait and see" attitude out there, on the part of both buyers and sellers.

Buyers are not pursuing many opportunities they would otherwise pursue because of the unavailability of financing. Sellers do not want to sell because they cannot get the valuation they could have gotten two years ago. Unless sellers are in dire situations that require them to sell assets, they are waiting and seeing.

To the extent deals are getting done, the terms are changing. The terms are much more buyer-friendly, and typically with sellers that have to sell. To the extent that there are loans that are financing deals, loans are very different from the loans we saw in the pre-credit crunch world. In the pre-credit crunch world, we saw a phenomenon called the "covenant lite loan," where the banks were willing to loan money with virtually no restrictions on the company until the loans were not being paid. Now, the interest rates are higher; the covenants are much tighter; and the loans are much more pro-lender.

Some of my clients are using non-traditional financing described above, as sources of acquisition funds. Other clients are focusing on restructuring of portfolio companies and looking at acquisitions of distressed assets and distressed debt securities. So my practice has become more diverse.

We are also seeing many companies going into bankruptcy, so there is an increase in bankruptcy work and workout work.

The advice I would give attorneys in this troubled economy does not vary much from the advice I would give in a good economy. Generally, it is to stay in touch with your clients; let them know you are there for them at this time; make sure you understand their legal needs; and do your best to address them. In this economy, that becomes more important than ever.

A transactional attorney can help clients by structuring alternative financing arrangements that address their needs, and by ensuring that whatever transaction is entered into contains the best terms for them under the circumstances. For example, an attorney can make sure that the acquisition agreements their clients enter into have the appropriate conditions to allow the clients to walk out of a deal that no longer makes sense. We can also make sure that the client has adequate indemnification protections for the acquired assets. We can help our clients look for innovative structures that would allow them to take advantage of the low asset valuations and finance the deals in this environment where financing is difficult to obtain. As this economy turns (and it is bound to, sooner or later), our clients are likely to remember what we did for them in troubled times.

Jane Greyf practices in Butzel Long's New York office, where she serves as the assistant office managing shareholder. She graduated from Columbia University School of Law (J.D., 1998), where she was a Harlan Fiske Stone Scholar, and New York University (B.A., magna cum laude, Phi Beta Kappa, 1995). Ms. Greyf's practice focuses on mergers and acquisitions, representing both acquiring and selling entities in various private and public leveraged buyout, merger and acquisition, and investment transactions.

Ms. Greyf has significant experience representing leveraged buyout sponsors, hedge funds, venture capital funds, and other private equity investors in various acquisitions, dispositions, investments, joint ventures, buyouts, tender offers, co-investments, and leveraged finance transactions. She also represents public and private companies in connection with various corporate and securities law issues, including corporate *governance and takeover defenses and general corporate matters. Ms. Greyf has significant experience in acquisitions and financings focused in the energy industry, including tax credit-based equity financings of renewable energy assets. Ms. Greyf's practice includes significant financial advisory representations.*

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