INSIDE THE MINDS

Understanding Legal Trends in the Private Equity and Venture Capital Market

Leading Lawyers on Navigating the Current Economy, Managing Risks, and Understanding Changing SEC Regulations

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Evolving Private Equity Markets

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Introduction

Private equity as an industry has been around for more than forty years. While the industry has been evolving over that period in many ways, the last few years have witnessed more change than ever before. The relationships between the funds and the investors, or limited partners, are changing as limited partners become more sophisticated, demanding, and vocal. Investors now come from every country and continent, with increasing visibility from government-controlled funds having mammoth amounts to invest and, therefore, increased bargaining power with the funds. Funds have become more specialized, investing in specific industry sectors or geographic regions. The rewards are potentially higher for funds in the right sector at the right time, but the risks can also be greater as a result of industry or geographic concentration.

Funds are also more highly regulated than ever before, highlighting the importance of an internal compliance function and increasing the risk of adverse publicity resulting from a regulatory review or investigation. The Securities and Exchange Commission (SEC) has become more aggressive in its review of private equity funds, and substantial resources are being devoted by both the government and the funds when it comes to regulatory compliance. The regulators in other countries are sure to follow.

Legal Trends in the Private Equity Market: SEC Presence

Today's private equity market can be analyzed at two levels—what takes place at the fund level and what transpires at the deal level. Over the last year or so, the most interesting developments have arisen at the fund level, where we are seeing a new world order in an industry that has largely functioned in an unregulated manner for many years.

Historically, many private equity funds were exempt from any registration with the SEC. As a result of changes in the law over the last several years, certain affiliates of the private equity funds register with the SEC as an investment adviser. This is not a surprising development, given that it has been estimated that private equity assets were around $3.5 trillion as of June 30, 2013,[1] and are almost certainly higher today.

[1] Andrew J. Bowden, Dir., Office of Compliance Inspections and Examinations, Speech at Private Equity International (PEI), Private Fund Compliance Forum 2014 (May 6, 2014),

A private equity adviser registered with the SEC is subject to potentially three types of examinations:

"Routine" exams involve extensive, on-site examinations. For advisers determined by the SEC staff to present higher regulatory risks, the SEC staff historically seeks to do routine exams every three years, though that timing has slipped in recent years. Advisers deemed by the SEC staff to be of lower regulatory risk are selected for examination randomly.

"For cause" exams are initiated when the SEC staff believes an adviser may be violating the law. These typically arise from client complaints, tips, or adverse publicity relating to the adviser, and are often done on an unannounced basis.

"Sweep" or "presence" exams are typically focused on advisers engaged in specified activities or in a particular geographic area. In 2014, the SEC staff examined approximately 10 percent of registered advisers, and has acknowledged that the number of routine exams has decreased due to resource issues. Nevertheless, the SEC presence has indeed been felt by the private equity industry, as most of the private equity funds undertook their first routine SEC exam in 2014.

The routine examination process starts with an inspection letter being provided to an adviser, typically with two weeks' notice of an impending examination. The SEC staff's site visit generally will involve:

1. Briefings/interviews with senior management, compliance, operations, portfolio managers, head of trading, marketing personnel, and others,
2. On-site document review;
3. Off-premises document review (e.g., for information provided electronically and copies of documents provided on-site);
4. Email/electronic document searches; and
5. Written questions.

The staff is generally receptive to "rolling" production of materials, but generally expects advisers to have information made available on a fairly timely basis. Routine examinations usually conclude with an exit interview

available at www.sec.gov/News/Speech/Detail/Speech/ 1370541735361#.VLPkXDso7cs.

where the adviser can review any major problem areas with the staff, get an indication of the reviewer's views or concerns, and potentially clarify any final areas where the staff may not fully understand an issue.

The majority of routine examinations result in some form of deficiency letter, which describes any practices or activities the staff found questionable. The SEC staff seeks to provide any deficiency letter within ninety days of the completion of the inspection. A private equity adviser will respond with a letter that describes corrective measures taken, or defending the adviser's position. The response letter is typically expected within thirty days of the deficiency letter. In cases where the SEC staff believes there is material, actionable misconduct, the exam staff may refer a matter to the SEC Division of Enforcement. An adviser typically is provided an opportunity to respond prior to any referral to enforcement, though the SEC staff is not required to provide that opportunity.

As a result of the 2014 routine exams, many private equity funds are addressing the issues identified through this process. For those funds that had a routine exam, they have responded to or are in the process of responding to the deficiency letters, including implementing changes to policies and procedures. Firms that have not yet had their first routing exam are nevertheless making changes to policies and procedures in response to feedback they have received from other funds or their legal, accounting, financial, and other advisors.

In May 2014, Andrew Bowden, the director of the SEC's Office of Compliance, Infractions, and Examinations, gave a speech entitled "Spreading Sunshine in Private Equity"[2] in which he was very critical of some of the practices the SEC was seeing in the private equity world. Most of these practices related to an inconsistency between the information funds disclosed to their limited partners concerning fund activities, and the actual management activities of the funds. As a result, the SEC is focused on three types of issues in this area:

The first area of focus for the SEC is the allocation of expenses—i.e., when a fund complex consisting of multiple funds allocates expenses between

[2] Andrew J. Bowden, Dir., Office of Compliance Inspections and Examinations, Speech at Private Equity International (PEI), Private Fund Compliance Forum 2014 (May 6, 2014), *available at* www.sec.gov/News/Speech/Detail/Speech/ 1370541735361#.VLPkXDso7cs.

those funds for various matters/transactions, and more importantly, between the fund complex and the managers of its individual funds.[3] The SEC has found that fund investors did not always receive full disclosure with respect to how fund managers are allocating expenses—in some cases, a fund disclosed one thing while managers did another, giving rise to an SEC action against that particular fund. There are also some gray areas that have not received a lot of attention because the SEC has not been fully involved in those areas. For example, when it comes to travel expenses for broken deals, should that be a fund-level expense that is borne by the limited partners or an expense that is borne by the fund manager? Some fund documents are very clear; others less so. In any event, the disclosure to the limited partners was often inadequate.

The second issue the SEC is eyeing is the use of consultants, or so-called operating partners or "executives in residence." Every large fund complex has a team of consultants available to them—i.e., executives in residence or operating managers. In some cases, consultants are hired by a fund's portfolio companies to handle specific projects; and the fees for those consultants are borne by the portfolio companies. As a result, the fund has been indirectly paying those expenses, which means the limited partner indirectly bears those expenses.

The SEC has criticized this practice, essentially saying that consultant expenses are a disguised backdoor fee that should have been paid or borne by the management company. Under normal circumstances, a consultant would be hired by the management company and his or her fees and expenses would be paid by the management company. However,

[3] The typical fund structure, simplifying to a great degree for tax complexity, involves a limited partnership of other pass-through entity (the fund), with a general partner controlled and owned by the principals of the private equity firm, and a separate management company, also controlled and owned by the principals of the private equity firm. The general partner typically receives a percentage of the profits of the fund (commonly known as the "carry") and the management company receives a flat annual fee tied to the commitments to the fund made by the limited partners. The management fee is intended to be used to pay the day-to-day expenses of the private equity firm (staff salaries, rent, utilities, costs relating to investment analysis, compliance costs, etc.). For example, if the carry is 20 percent and the management fee is 1 percent, a $1 billion fund that earns 10 percent would expect to pay $20 million to the general partner for the carry (20 percent of $100 million) and $10 million to the management company (1 percent of $1 billion). These amounts are, however, highly negotiated with the limited partners, and may vary based on amount invested, and whether capital has been called or not, etc.

when a fund manager has the portfolio company retain the consultant, the manager has effectively pushed those expenses down to the fund level, and the limited partners then bear those costs.

For example, let us say the fund manager thinks it needs the expertise of an information technology consultant for a technology project it is contemplating for one or more of its portfolio companies. If the management company hires the consultant for $250,000, that fee would come out of the management company's fee from the fund and thereby reduce amounts the management company has available to it to spend on other expenses (including paying the owners/partners of the private equity firm). If, however, the fund has one of its portfolio companies retain the consultant, the $250,000 expense reduces the income of the portfolio company. The decrease in value may indirectly be borne by the general partner since 20 percent of the value decline, if any, as a result of this expense is effectively borne by the general partner, but 80 percent of the value decline, if any, is borne by the limited partners.

The third area with which the SEC has shown concern involves monitoring fees. Many of the big funds have imposed on their portfolio companies a regular monitoring fee or an upper management fee that is paid by the portfolio company during the lifespan of the investment. Many of these agreements have acceleration provisions based on a long-term fee payment arrangement. An investment agreement may have a ten-year term, with an acceleration of the remaining payments due if there is an exit by the private equity fund during that time—i.e., if there is an initial public offering of the company or if the company is ultimately sold by the private equity manager. For example, assume a private equity firm has an agreement with its portfolio company with a ten-year term providing for an annual monitoring fee equal to 1 percent of the equity invested by the private equity firm. If the firm invested $200 million, there would be an annual fee of $2 million, plus other fees potentially for merger and acquisition or capital markets transactions. If the portfolio company is sold to a strategic investor in year six, the fees due for the remaining four years of the agreement would be accelerated, and an additional $8 million must be paid in year six. The SEC criticized the disclosures made to limited partners about these acceleration provisions, which puts large amounts of money into the pocket of the fund manager. If you assume the sales price for the portfolio company is reduced by $8 million,[4] all of these sale proceeds (or at least 80 percent if the general partner has a 20 percent carry) would have been paid to the limited partners; instead 100 percent of this amount goes to the private equity firm.

Private Equity Fundraising and Deal-Making Trends

The year 2014 was very good for private equity funds with respect to fundraising—more than 200 private equity funds raised over $125 billion through September 30, 2014. At the same time, several factors combined to create significantly increased competition with respect to transactions, which made it harder for firms to get deals across the finish line. Essentially, mega-deals were not a big part of the deal-making landscape for private equity this year.

Deal making became more competitive for a number of reasons, including: the increase in capital available to the private equity industry; the return of strategic buyers to the market; limitations on the amount of leverage allowed to be used to finance transactions; and high deal valuations driven by the auction process.

Perhaps most importantly, strategic investors came off the sidelines in a meaningful way in 2014. Typically, when private equity funds are competing with strategic buyers, they lose. Strategic buyers are inherently able to pay more for a company because they can combine it with their existing business and create synergies that private equity funds do not often have the luxury of including in their model. Synergies can exist in a number of ways, but the most common examples are probably administrative costs or sales and marketing. A strategic buyer often has a senior management team in place (chief executive officer, chief financial officer, chief operating officer, general counsel, etc.), so many of these positions at the target are often eliminated as redundant. Similarly, a strategic buyer with an established sales force can often take the products sold by the target and add them to the suite of products its sales force offers without much incremental cost. Think of a pharmaceutical company buying another pharmaceutical company. The sales force now has more products in their

[4] In a typical sales transaction, the purchase price is reduced by closing expenses paid by the target to the seller or on behalf of the seller. Fees of this type would likely be viewed as selling expenses.

bag to offer the doctors, but the buyer does not necessarily need a bigger sales force to sell the combined product offering. Private equity buyers do not have this luxury. As a result, a strategic buyer can often take cost out of the target that makes the target, in essence, more profitable to the strategic buyer than to the private equity buyer, enabling the strategic buyer to pay more for the target.

The year 2014 also was tougher for private equity deal making because the Federal Reserve moved aggressively to limit how much leverage banks can extend to private equity buyers. This affected the attractiveness of some deals to banks, and the ability of some sponsors to get financing. The Fed took the position that banks should not be extending leverage above six times[5] on private equity deals; and this stance has led some banks to pull back from or out of deals they otherwise might consider, or from so-called mega-deals. In fact, the recent Pet Smart deal was hailed as the biggest private equity buyout of the year, yet at $8.7 billion, it was not an enormous deal.

Private equity deal making also was affected this year by high valuations, driven by the auction process, which made it difficult for private equity investors to match their investment model with sellers' expectations of robust sales processes and prices. There was a marked increase in the competitiveness of auctions. Virtually no assets are going to market today without some kind of auction process, which makes it difficult for private equity investors to compete with other buyers, because everybody is chasing after the same transactions, driving up deal valuations.

Ultimately, the increased competition and higher valuations have enabled sellers to become more aggressive in the terms they expect buyers to agree to in the transaction documents. For example, we have seen a marked shift in the last year or so in sellers' bid documents in the representations and warranties they are prepared to make as part of a sales process, and the post-closing protections they are prepared to offer buyers. In years past, the

[5] Buyers often value a business as a multiple of cash flow or earnings before interest, depreciation, and amortization (EBITDA). For example, if a business has EBITDA of $100 million and sells for eight times EBITDA, that would imply a purchase price of $800 million. The Fed is concerned about banks that were extending credit of more than six times EBIDTA for a transaction such as this. Essentially, this means that notwithstanding the multiple (e.g., eight, ten, twelve), the banks will lend up to six times, and the private equity firm generally funds the balance with equity or subordinated debt.

expectation was that there would be representations and warranties made by the seller as to the business, liabilities, and related matters, and that there would be reasonable indemnities supporting those representations and warranties, including reasonable survival periods. In most cases, an escrow would be established for the buyer to access post-closing if a problem arose with the business it had purchased. While post-closing escrows were most often established if specific problems arose in the course of due diligence, they often were even created in instances in which it was determined the seller had a relatively clean business.

These days, however, we are seeing more deals involving a bid document that proposes comparatively weak representations and warranties, no indemnities, and, as a result, no post-closing escrow. The sellers expect the buyers to rely on representation and warranty insurance—a trend that represents another huge change in the market. Even a few years ago, this type of insurance was not attractive, largely because it was expensive and untested; there was a general lack of trust and familiarity with the product. Today, every private equity firm is looking at this type of insurance, and most have used it both as a buyer and as a seller. During the auction process, sellers frequently tell buyers they should look to representation and warranty insurance as their sole recourse in the event that they find a problem with the business post-closing. This trend has dramatically changed the deal dynamics in the private equity investment world.

Global Issues Affecting the Private Equity Markets

From a global perspective, the US market continues to be the most attractive place in which to do business. Certainly, global private equity firms are more bullish on Europe than they were a year or two ago, but there is still a cautionary note when it comes to investments in that region. The Euro has declined against the dollar materially over the last year, and Greece continues to be in the headlines as the pundits discuss whether Greece will leave the European Union. France's economy continues to be weak, and many of the Eurozone countries struggle to attract new investments given highly regulated markets, with high and burdensome labor costs. Asia continues to be an attractive market for private equity investors simply because of the sheer size of this market, and Latin America is an exciting emerging market for many private equity funds—particularly those in the energy space—notwithstanding the reduction in the price of oil we have experienced in 2014. An issue for private equity investors is whether this is a long-term or short-term phenomenon, and whether there are still interesting opportunities in the energy and energy services sector. Many funds experienced a material decline in the value of their existing portfolio companies, especially the public companies. However, there is a tremendous amount of capital targeted for energy, and it is likely that in the long term this will continue to be an attractive investment thesis for private equity investors.

Investors remain cautious when doing private equity deals outside of the United States, primarily because the risk of doing these deals is often higher in other markets. For example, some markets entail political risk—i.e., if you were doing private equity deals in Russia two years ago, it is unlikely that you would be doing those kinds of deals today. Also, there are considerable financial risks involved when doing business in an emerging market, which tends to be a much more volatile market. There is political risk, economic risk, currency risk, and the risk of doing business where the rules are less clear or undeveloped, what might be called the "rule of law" risk. Most other jurisdictions do not provide the security the United States or most of Europe does when it comes to respecting the integrity of a contract, and whether a buyer is going to get what they think they are getting, based on the contractual terms they negotiate.

In addition, there is a corruption risk in many emerging markets, relating to anti-bribery and Foreign Corrupt Practices Act (FCPA)[6]-type violations. Essentially, there is a higher risk of doing business in such markets because of the increased likelihood of such violations, and these violations often are accompanied by significant potential liability. One need go no further than the front pages of the business section of the newspaper to see some examples of the fines and penalties companies have paid in the last year or two to regulators in the United States and United Kingdom for violating the FCPA and UK Anti-Bribery Act.[7] Consequently, a premium must be placed on conducting good due diligence in private equity transactions in all types of markets to ensure you are not engaged in a deal that will lead to anti-bribery and FCPA-type problems. For example, last year the European

[6] Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494.
[7] Bribery Act, 2010, c. 23 (U.K.).

Union fined Goldman Sachs for its role as a private equity buyer of a business that had engaged in anti-competitive behavior—i.e., it participated in a cartel/price fixing transaction.

Previously, investors believed that such fines should be reserved for industrial parent companies that actively managed their subsidiaries—and not imposed on private equity funds and financial buyers of businesses—but the European Union has disabused investors of this notion. The European Union has determined that if a party is the owner of a business, manages the business, exercises decisive control over the board, and has people on the board participating in budgeting and monitoring decisions, that party has liability. As a result, private equity buyers have become more careful and deliberative in their diligence for transactions in some of the emerging markets in the European Union and elsewhere, because the fines that may be imposed for any corruption-related violations are material and can seriously impact the return on investment. More importantly, the private equity firm's reputation can be seriously damaged in a local market or more broadly with the adverse publicity associated with these types of matters.

Economic Conditions Affecting the Private Equity Market

As noted, the valuations we currently are seeing in the private equity market are extremely high, which has made it somewhat more challenging to get deals done. At the same time, the capital markets have been positive—i.e., there is an abundance of capital available for transactions. In other words, notwithstanding the Federal Reserve's recent actions, there is still a great deal of leverage for investors who wish to complete private equity transactions. The good news for sellers is that there is a lot of money available for those who are looking to invest.

The US economy is, generally speaking, doing well; therefore, most people are optimistic about the short- to medium-term prospects of a business deal. While the state of the economy has increased competition and valuations, which has had a negative impact on the ability to get deals done as a buyer, these trends generally have been good for the US business community. On the other hand, there are very few international economies that are as strong as the US economy is right now. For a variety of reasons, the United States seems to have put most of the issues relating to the Great

Recession behind it, as many other countries continue to struggle with them. Therefore, while there are certainly kernels of opportunity in other jurisdictions and money is being deployed in those countries, most foreign economies are not as robust as the US economy is at this time.

Legal Trends in Secondary Markets

The market for buying and selling limited partnership interests of private equity funds is much more liquid than it has been in previous years. There are more opportunities to buy and sell these stakes, and such transactions have become a much more frequent occurrence.

One reason these transactions have become more commonplace is because some big institutions, such as pension plans, have decided to scale back; and when they scale back, they engage in massive secondary trades. In some cases, this is due to historical reasons—i.e., when people resign or retire from a firm or the business world, they want to obtain liquidity from what is otherwise an illiquid investment. Consequently, the market has become much more accustomed to dealing with the secondary trading in these limited partnership units. There are now many investors dedicated to buying and selling private equity interests in the secondary market. By some estimates, there was approximately $45 billion available for secondary sales at the end of 2013 and another $30 billion expected to be available in 2014.[8]

Primary Challenges Facing Private Equity Investors

One of the biggest economic challenges facing private equity investors is that the amount of money generally available for investment has made it difficult from a competitive perspective to get a deal across the finish line—especially in an auction environment. As a result, private equity investors have a few options available to them. One option is to lower their internal rate of return recommendations so they can pay more than the next guy. Investors who choose this option are paying more for a company—not

[8] Brian Cantwell, *Evercore: Secondary Funds Target $30 Billion*, SECONDARIES INVESTOR (Apr. 14, 2014), www.secondariesinvestor.com/evercore-30bn-dry-powder-2014/. *See also* Ryan Dezember, *Secondary Private-Equity Investments Expected to Hit Record Year*, WALL ST. J., Apr. 23, 2014, www.wsj.com/articles/ SB10001424052702304788404579520063 776851686.

because they are going to do something to the business that is going to make it worth more money, but simply because they are prepared to accept a lower rate of return. Of course, this is not a particularly attractive outcome for anybody, including the limited partners who invest in the business; and therefore, it is not a good long-term strategy.

Another option to get deals done in a market with increased competition and higher valuations is to seek to avoid the auction process by creating proprietary deal flow. Nearly every private equity firm is seeking to link up with operators, managers, and executives with whom they can establish relationships and hopefully effect transactions outside of an auction process, whether they are making an investment in a company or starting up a new company. But creating proprietary deal flow is a great challenge for private equity investors; it is much easier to articulate as a strategy than it is to implement. The private equity firm needs to persuade a manager that there is some benefit to linking up with a private equity firm. They need to show they can bring domain expertise and other assets to the boardroom besides a checkbook—something that will entice a management team and a board to talk to a private equity firm outside of a full-blown auction process. Private equity firms spend an enormous amount of time and money cultivating these relationships. In the long run, if the firm can sidestep an auction, the investment is well worth it.

Private equity funds also face added challenges from their investors, who have become more assertive and demanding (as noted), and are placing greater pressure on funds with regard to their management fees. Therefore, fund managers are becoming increasingly creative in terms of structuring different deals for different investors, based on when they come into the fund, how much they invest in the fund, and whether they co-invest in future opportunities. More flexibility has been introduced into the fund structure than ever before. However, with greater flexibility comes more complexity. Going forward, private equity funds will face greater complexity in dealing with limited partners who are going to be more demanding and are going to expect more from their private equity sponsors. If you were to look at an organization chart for a private equity fund ten years ago, you would have seen a fairly basic structure with a fund, a general partner, and a management company. Today, the organization chart looks like something from an organic chemistry class—lots of boxes for parallel funds, offshore funds, different investors, etc.

Another challenge faced by private equity funds today is the never-ending quest for some form of permanent capital. A private equity fund, at its core, has a limited lifespan. If private equity sponsors do not raise capital for their next fund, they will be out of business in the next seven to ten years—a troubling prospect for the private equity industry. As a result, private equity sponsors work in what essentially has become an ongoing capital-raising environment, in which they spend a few years working on raising capital for a fund, and as they launch that fund, they immediately start thinking about the capital they need to raise for the next fund three to five years out.

The bigger players in this area have full-time teams dedicated to capital-raising activities, and are engaged in a virtual cycle of fundraising. Naturally, they would love to find a way to attract more permanent capital into the system so they would not have to engage in capital raising on an ongoing basis. Consequently, many are focused on whether there is a longer-term solution on the horizon.

The solution may originate with sovereign wealth funds, which are looking hard at developing more permanent capital structures, or from big pension plans prepared to entertain this kind of structure. Alternatively, the solution may come from a dramatic shift in the law, which would likely be required to allow retirement money into private equity funds. In any case, a lot of time and attention is being spent by the private equity industry on developing a solution to the current lack of permanent capital.

Finding a Good Private Equity/Venture Capital Acquisition Target

A company that represents a good target for a private equity acquisition almost certainly starts with a company that generates cash flow, because cash flow is needed to service debt—and most of these transactions only work if some portion of the purchase price is paid with debt. A private equity acquisition requires leverage and equity. To finance the leverage, there needs to be sufficient cash flow from the target business. Accordingly, a business without a positive cash flow generally is not a good candidate for a private equity acquisition.

However, a company without positive cash flow still may be a good candidate for an investment; certainly, venture capitalists frequently invest in businesses that do not have positive cash flow. For example, venture capitalists often invest in start-ups that do not yet generate positive cash flow, and will not do so until some point in the future. In fact, the main reason venture capitalists invest in start-ups is they expect the equity value of a start-up company to increase. For example, a biotech company generally does not generate positive cash flow and is not very leverageable. Consequently, such a company tends to be a more attractive investment target for venture capitalists—or perhaps private equity sponsors who are prepared to make a minority investment in a business in the hope that it will become more profitable or valuable over time.

It is also important that a target company have good management. While it is certainly the case that private equity and venture capital investors are capable of bringing in a management team, most of them probably would say they prefer to invest in a company with a solid management team already in place. Because private equity and venture capital investors are not like strategic investors with existing management teams in place, they like to invest in companies with management teams that have an established track record, but that need the capital venture capitalists and private equity sponsors can provide, along with domain expertise. Savvy management teams will value this domain expertise, which both private equity and venture capital investors can bring to the boardroom. Many start-ups and early-stage companies need not only capital to grow their business, but assistance in growing the business. This assistance includes assisting management in assessing whether the current management team/founders have the skills to grow the company, accessing additional sources of capital from other investors or lenders, assessing when and how to consider a public offering, evaluating acquisition and growth strategies, developing sales and marketing teams, and providing guidance on many other similar issues.

Third on the list of qualities private equity and venture capital investors look for in an acquisition target are industries or businesses with substantial growth opportunities. Consequently, private equity and venture capital investors spend a lot of time focusing on the size of the target's market, the market share and role the target company plays in that market, and whether it is reasonable to assume the company can increase its share of that market in a meaningful way over a reasonably short period of time. This analysis involves identifying what the target's market is, the trends in this market, if it is a local or global market, and any barriers to entry. For instance, is it a market where a huge industrial company can swoop in and take it over, or is it a market where the target's proprietary expertise or information is protected through a patent or otherwise, so the barriers to entry are fairly high? In the technology space, for example, the investors will typically look at the competitive landscape. Is Google or another well-capitalized company already in this space? Could they be if they wanted to be without much effort? In some cases, the answer may be that the competitor could buy the company at some point, which is precisely why the investor should be willing to invest. But those questions need to be asked and answered in a way that satisfies the investor that the risk is worth taking.

When to Seek Investments from Private Equity or Venture Capital Sources

In some cases, a venture capitalist is basically the only provider of capital to a company. This is generally the case when a company is at a stage where it is not mature enough or does not have sufficient, predictable cash flow to obtain lender financing. Banks are not viable investors for such a company, and the company is not at a stage of its life where it is ready to go to the public market to obtain financing—i.e., an initial public offering is not a viable option. Therefore, the next best option is to obtain financing from venture capitalists that are willing to take the investment risk that others—i.e., lenders or the public markets—are not prepared to take.

Of course, a venture capital target needs to realize they are obtaining fairly expensive capital, because venture capitalists generally have high expectations with respect to returns. However, in many cases a company does not have many other options; it may have completed an angel financing round, which involves obtaining financing from family members, friends, and wealthy people who want to assist a start-up, but the company has grown to a point where they need more sizeable capital—and that capital is only available through institutional investors such as venture capitalists.

The analysis is similar for a company looking for a private equity investor. Again, among the advantages private equity investors bring to the table are domain expertise; in other words, they can bring contacts, relationships, and industry knowledge to the boardroom, thereby serving as a real asset to the company. They also can assist the company in strategic thinking; i.e., they can help the company prepare for future merger and acquisition transactions or capital raises. Many private equity firms have in-house capital market departments with professionals who are intelligent, sophisticated, and aggressive in negotiating on behalf of their portfolio companies, effectively providing their portfolio companies with leverage in their dealings with other parties they otherwise would not have on a standalone basis.

Private equity investors also provide the ability to do something quickly. For example, say a company wants to finance an acquisition and while it is going to finance a portion of the purchase price with debt, it also needs an infusion of equity capital. In such a case, it is not viable to hinge an acquisition on a public offering, which brings all sorts of risks and timing delays for both the buyer and seller. A better solution is to find a private equity sponsor that will agree to provide the capital to the company—which, in turn, would be used to finance the purchase price. This type of arrangement gives the buyer the ability to go to the seller and say, "I have committed capital to do the deal."

Shifting Sales Structures in the Private Equity Market

As previously noted, the private equity market has become much more aggressive in recent years. Valuation has become a real issue, and it has become a seller's market.

When the credit crunch occurred, there was a marked decline in valuations and a gap in expectations between what sellers wanted to sell their businesses for and what buyers were prepared to pay. However, the situation has evened itself out over the last couple of years, and, in fact, the pendulum has swung the other way. Now, as a result of fairly robust capital markets and a strong economy, sellers' expectations of value are extremely high. Therefore, the real challenge for private equity buyers is ensuring they do not overpay for an asset. As also previously noted, the terms sellers are demanding are much more seller-favorable. Sellers increasingly are refusing to offer indemnities. As noted above, they are watering down representations and warranties, and they are not providing escrows or any survival periods for representations and warranties after closing. In many cases, they are telling buyers they should resort to representation and warranty insurance as their sole recourse if they want any protection regarding the state of affairs of the business post-closing.

Risks Faced by Companies Seeking Private Equity Investments

The biggest risk faced by companies seeking private equity investments is the fact that the cost of capital is high; the return expectations for a private equity investor are in the low to mid-twenties. Private equity investment is an expensive source of capital for a company, and companies need to recognize this.

Companies also should understand that when they bring a private equity investor into the boardroom, they have introduced a very sophisticated and demanding investor. Private equity investors are extremely smart and savvy, and they demand results. It is unlikely that the company's management will have an easy life while working with a private equity investor, particularly if management does not perform in a way that leads the private equity investor to believe their business can succeed following a private equity investment. A private equity investor can be your best friend if you perform—indeed, many managers and chief executive officers have gotten rich with a private equity investor at their elbow—but they can be a ruthless investor if you fail to perform. Many chief executive officers of public companies want to take their companies private because of the expectations of quarter-to-quarter performance demanded by public markets. There are many good and valid reasons for taking a company public. Switching owners from public investors to private equity investors on the assumption that management will necessarily have a better master is not necessarily the case.

Features of a Successful Investment Capital Deal

Every private equity investment is different; therefore, there is no template that says in effect, "This is a good deal" or "This is a bad deal." The deal dynamics generally depend on whether a target company is desperate for capital or whether it would just be nice to have; the strength of the company's balance sheet; the company's prospects; the company's standing within its industry; and the strength of the company's management team and competition.

Likewise, the hallmarks of a good deal, from a target company's perspective, include whether it was able to negotiate acceptable governance and economic terms. In other words, if the company performs in accordance with what it said it would do, everyone wins—the company's shareholders other than the private equity sponsor, the private equity sponsor itself, and the management team.

Best Practices for Choosing Investment Targets

Private equity firms view the practices involved in choosing investment targets differently from each other. For example, there are private equity investors that look to invest in distressed companies because they see the biggest opportunities in these types of companies. The risks are often greater because if the thesis fails to pan out, the company is likely bankrupt and the equity worthless. However, the rewards may be greater for the successful investments. For this reason, there are many private equity investors that would never want to invest in a distressed company; it is not part of their business model.

There are private equity funds that have been established in almost every industry sector, such as healthcare, energy, and technology. There are funds focused on specific geographic regions, including those based in Asia, various emerging markets, Latin America, as well as domestic/US funds. Private equity sponsors tend to invest in where they think they have unique expertise, and where they think there will be market demand for their limited partners. Much depends on what a private equity fund's limited partners are looking for. For instance, if the energy sector is hot and sovereign wealth investors are looking for energy investments, there will be a large number of energy funds created to meet that demand. Similarly, if the real estate market heats up, there will be a large number of real estate funds formed.

Investors look at the private equity firm's track record in the space, as well as factors that may differentiate the firm. For example, a firm that has been operating in a foreign country for twenty-five years may have an advantage over a newcomer from the limited partner's point of view. Similarly, a firm that has focused in a particular area with several prior successful funds will have an advantage over a firm starting its first fund in a particular area or region.

Conclusion

One of the major takeaways in today's private equity market is that on the deal side, the current trend of limited indemnities and scaled-back representations and warranties is not going to be reversed in the near future. Rather, this trend is likely to continue unless there is a big blow-up in the deal-making process due to a specific isolated problem, or if there is a renewed focus on a particular issue. For example, in 1999, the "year 2K issue" became prevalent in deal making. In the early 2000s, after blow-ups at companies such as Enron and WorldCom, there was renewed emphasis on internal controls. Today, more attention is paid to bribery and related issues that can result in large fines or penalties. In both the European and US markets, when buyers and sellers cut a deal, the buyer must beware—i.e., *caveat emptor*. It is up to the buyer to do due diligence to assess its risk, and then price this risk into the deal to protect its company, in whatever way it thinks is appropriate, on its own nickel. This usually means the buyer needs to obtain insurance.

One evolving trend that should be noted is that activists in the public market have had enormous success over the last year in getting into the boardroom through proxy fights and threatened proxy fights. In fact, activists have reached a point in 2014 where more than 70 percent of their campaigns have been successful in terms of obtaining board representation. Each campaign is different of course, but many have as their theme the sale of the company, or a spinoff or divestiture of one or more divisions. For private equity investors, this means that as a result of activists stirring the pot, there could be more "going private" transactions.

A few years ago, boards might have been more willing to fight these activists, taking the stance that they have everything under control and are prepared to take on the risk of a proxy fight. These days, however, companies know that if an activist shows up at your door, there is a very high likelihood that the company will lose a proxy fight. As a result, if an activist approaches a public company and says, "I think you should considering a 'going private' transaction," there is a much higher likelihood that the board is going to seriously consider that suggestion. This inures to the benefit of private equity sponsors because they are typically the buyers in these "going private" transactions.

Consequently, we could see a renewed trend towards "going private" transactions, assuming the leverage for such deals is still available from banks, which it is likely to be at some level. The levels of leverage may be reduced in comparison to the past year or so, but nonetheless, there likely will be opportunities created by activists that could benefit private equity sponsors.

My advice to attorneys who work in this area is to keep in mind that there is no substitute for expertise, and this is an area where one should not dabble. Private equity sponsors are extremely sophisticated and demanding, and they are very good at what they do. What they need is a good business advisor who can help them assess their risk in relation to an investment, and then help them make a judgment as to whether the risk is acceptable or not. They do not want advisors who always say yes or no. They do not want advisors that simply identify the problem. That is the first step of course, but what they want are advisors who can solve the problems and help them make the hard judgments they are required to make routinely.

Key Takeaways

- Regulatory burdens for private equity funds will increase over time, and funds need to be prepared for this. All of the firms in the private equity world are gearing up for their SEC exams, or taking corrective action as a result of their exams. We are seeing a new world order in an industry that has functioned in an unregulated way for many years.
- Investors are more sophisticated than ever, and they are now and will continue to be more demanding of private equity firms when it comes to fees and carry.
- Deals are difficult to source and consummate as a result of an abundance of capital. Sellers are likely to continue to be aggressive with terms under current market conditions. We are also seeing more deals involving a bid document that proposes no indemnities, representations and warranties, or escrow accounting. Instead, sellers are expecting that buyers will rely on representations and warranties insurance.
- Remain cautious when doing private equity deals outside of the United States. Some markets entail political risk. Also, there are considerable financial risks involved when doing business in emerging markets, which tend to be much more volatile. There is also a rule of law risk that accompanies deal making in other countries; most jurisdictions do not provide the safe haven the United States or most of Europe does when it comes to respecting the integrity of a contract.
- Private equity continues to be a great source of capital for portfolio companies, providing capital and domain expertise.

- Private equity continues to be a great investment option for sophisticated and institutional investors.
- Keep in mind that there is no substitute for expertise, and this is an area where one should not dabble. Private equity sponsors need a good business advisor who can help them assess their risk in relation to an investment, and then help them make a judgment as to whether the risk is an acceptable or unacceptable one.

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