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Show me the money: Deal security in energy private equity

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Private equity buyouts in the energy industry are getting larger. Average deal size so far in 2022 is $766.7mn, up from $466.3mn in 2021 according to Preqin data. As competition among buyers heats up, sellers are frequently turning to deposit features to de-risk energy asset-focused dispositions. Although non-energy sellers rely on traditional reverse termination fees from private equity buyers or their affiliates, energy asset-focused sales historically involve deposits, similar to real estate transactions.

A cash deposit, typically paid into an escrow account, offers obvious advantages for a seller. The seller limits (i) its risk of litigation to recover the deal security if the buyer fails to close and (ii) its need to conduct financial diligence of the buyer, which may be complicated if the buyer is comprised of a group of private equity sponsors.

If the deposit value is high enough, the seller may concede the right to sue the buyer for specific performance as well as damages beyond the deposit amount. The basic economic rationale for foregoing such an equitable remedy is that the size of the deposit reasonably compensates the seller for the buyer's failure to close.

From a private equity buyer's perspective, a deposit feature is problematic, at least relative to typical deal security in leveraged buyouts. The first risk is the size of a deposit. Energy deal deposits are often expected to be higher than a typical reverse termination fee, particularly if there is no specific performance remedy against the buyer. The second risk is that the sponsor has to actually call capital and fund the deposit ahead of closing the transaction, which has a real cost in terms of its investors' capital.

Additionally, to the extent the sponsor plans to leverage the investment, and the debt is not fully committed at signing, then the sponsor is taking a significant risk by funding a deposit. If the buyer comprises a group of sponsors, then it can be complicated to organize the buyer group solely for the purpose of funding that deposit at the time of signing, and dealing with the outcome of a forfeited deposit.

As buyer/sponsor structures become more complicated, and competition among buyers grows, sellers may increasingly push for deposit features in the energy space. A properly sized deposit may make a buyer's bid more attractive and may incentivize a seller to forego other traditional deal security. While a deposit feature may expedite the transaction process, buyers will need to weigh the prospective benefit against the real economic risk and additional administrative burdens that a deposit feature presents over a reverse termination fee or other traditional deal security.

Archie Fallon is a partner in Willkie's Corporate & Financial Services Department and Co-Chair of the Firm's Power & Renewable Energy; Environmental, Social & Governance; and Project Finance practice groups. He represents private equity funds and corporate clients in strategic transactions primarily in the energy, infrastructure, and technology sectors, and has particular experience advising on platform investments, mergers and acquisitions, financings, joint ventures, recapitalizations, and project development.

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