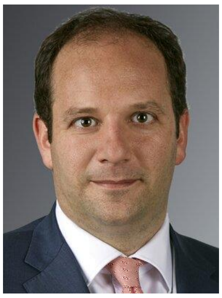
How Market Challenges Are Affecting Deal-Making Trends

By **Alvaro Membrillera and Anna Pollak** (July 6, 2022)



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Having benefited from a long era of low inflation and a predictable macroeconomic environment, as well as a relatively stable political landscape, private equity investors are adjusting to a new period of volatility and uncertainty, and are facing, among other challenges, surging inflation and interest rates, making securing a deal and accurately valuing assets more difficult.

Bridging the Valuation Gap

In the limelight of commercial discussions, deal makers need to address diverging expectations on valuation. While sellers remain focused on divesting their assets at very high valuation multiples in line with historical expectations, purchasers are keen to adjust valuations to adequately reflect the new, more challenging market environment.

New challenges include significantly reduced valuation multiples for public companies, which weigh on valuation multiples for comparable private companies in the same industries; the current uncertain geopolitical situation; and higher interest rates coupled with volatile macroeconomic conditions, which translate into reluctance by debt providers to finance acquisitions.

Consequently, various trends in deal making are emerging to bridge valuation gaps and address financing concerns:

Earnouts

Traditionally, earnout mechanisms involve increasing the purchase price by reference to the future performance of a target business, and they have been used in particular in transactions in which there was a different perception between the parties on the potential growth of the target.

Nowadays, earnouts are also being proposed as a way for purchasers to meet the nominal purchase price target set out by sellers in any type of transaction, while at the same time deferring the funding of the higher purchase price, only payable if and when the target meets the agreed future performance threshold.

As such, earnouts are becoming highly successful in acting as a vendor financing tool and in managing differing expectations on valuation between the parties that arise due to perceived risks around the target company's future performance.

Rollovers

Members of management are commonly requested to reinvest a substantial portion of the proceeds achieved in an exit into the new investor's acquisition structure. This rollover mechanism is a popular tool to align incentives and increase the skin in the game of management teams and founders beyond the management incentive plan.

Traditionally, purely financial owners have been able to divest their entire stake at exit, demanding that any potential upsides from expected synergies from the transaction are reflected in the agreed purchase price.

However, recent increased uncertainty has resulted in a revival of rollovers beyond the reinvestment of management teams and founders. This renewed interest in rollovers by financial investors is in part explained by sellers feeling that they can have another bite at the apple.

By agreeing to a rollover, sellers can benefit from both the synergies that may follow from the transaction and the upside that the purchaser can generate with the target, while securing an initial cash return and de-risking their own investment.

From the purchaser's perspective, the rollover is a vote of confidence from the seller on the future prospects of the target, which provides some degree of comfort on the valuation. It also allows the purchaser to distinguish itself from other bidders on something other than the cash purchase price as, after all, it is only the purchaser that can deliver those synergies or future upside.

Finally, the rollover also results in a reduction of the cash needed by the buyer to close the transaction, and hence it reduces the pressure on debt providers.

Deferred Consideration

Although deferred consideration mechanics do not address gaps in valuation between a buyer and a seller, they have increased in popularity. They enable investors to structure a transaction with adequate leverage and return on equity, while reducing cash needed at completion and therefore reducing pressure on financing considerations.

Purchasers try to structure the deferred consideration payment as an obligation linked to a liquidity event — such as a dividend recap, a total or partial sale, an initial public offering or a distribution payable by one of the acquisition vehicles outside the credit group — so that the deferred consideration payment obligation is senior in right of payment to any equity claim, but is subordinated to the acquisition financing.

Completion Accounts

Recent M&A activity, in particular in relation to mid-cap transactions, has also seen a moderate comeback of completion accounts and subsequent shift away from the more common European locked-box market practice, in which the only adjustment to the purchase price is a potential ticking fee introduced to compensate for the cost of capital from the locked-box date to the completion date.

Similar to the deferred consideration mechanics, completion accounts structures do not address differing expectations on valuation, but are a useful instrument to reduce the risk of current trading volatility and big movements in working capital.

Deal Financing

Private equity firms have benefited over the last decade from market conditions that supported readily available third-party debt at relatively low interest rates, which facilitated many investments. The new market conditions have reduced appetite among banks to provide acquisition financing, in turn resulting in the following trends:

Direct Lending

The mainstream banks and traditional debt providers have recently reduced their supply of debt financings in light of the significant volatility in capital markets, putting on hold an increased number of contemplated high-yield bond offerings, syndicated facilities and other acquisition financing.

Consequently, private equity investors are seeking alternative sources of financing, now often borrowing private debt, including from each other's credit arms, to fund leveraged buyouts.

While direct lending is suitable to provide investors with flexible and speedy execution, it often comes at a higher price that has to be factored into investors' valuation models and puts pressure on the purchase price buyers can offer to sellers.

Timing Considerations

Adjustment to the current market environment is also required when it comes to structuring sales processes. In stable macroeconomic environments, investors would usually be requested to show up with fully funded offers at the final bid stage so that deals could be signed imminently after the selection of a preferred bidder.

Due to recent reluctance by banks to provide enforceable financing commitments to numerous bidders, sale processes need to budget for additional time to align terms and finalize financing proposals following the selection of a preferred bidder and prior to execution of a sale and purchase agreement.

Commitment Letters

Current market dynamics in relation to financing availability have also led to limitations in the scope of commitment letters issued by private equity firms' investment funds.

In particular, investment funds have become increasingly reluctant to cover the full purchase price, including the debt component of the consideration, in their commitment letters given the heightened risks involved with securing debt financing between signing and closing of a transaction.

In the recent past, private equity purchasers, particularly in fast-paced deals in which a corporate buyer with a balance sheet could offer certain funds without running an acquisition financing process with lenders, may have offered to underwrite the entire purchase price with a commitment letter given that they had a relatively high certainty that they could secure third party debt to replace a portion of their commitment prior to closing.

This has now become less common, and private equity purchasers are not prepared to bridge the funding risk with their fund commitments and transactions, and therefore require additional lead time to allow negotiations with lenders prior to signing.

Notwithstanding the current climate, to date, the reduced financing availability has not caused parties to condition definitive transaction documentation on the purchaser's ability to obtain financing, and sellers continue to insist — and purchasers are generally accepting — that the purchaser has certain funds at signing.

Process Considerations

The foregoing developments in deal dynamics shaped by current macroeconomic conditions and the related decrease of deal certainty have led to private equity investors being more reluctant to incur substantial costs, in particular in the form of adviser fees, in the early stages of a competitive auction process.

As such, investors tend to opt out of sales processes early if they do not see a clear path to success or a strong strategic rationale to chase an asset aggressively, leading to a fear of busted auctions on the sell side.

In order to incentivize bidders to continue to pursue a deal, sellers now tend to run narrower auction processes with increased flexibility for investors who are best placed to be the purchasers, rather than an indiscriminate broad auction process focused purely on maximizing valuation.

The challenges and trends outlined may present obstacles in settling on pricing for a deal as well as achieving deal certainty. However, such uncertainties can also create opportunities, and private equity firms may be able to turn volatility and market disruptions to their advantage.

In fact, general partners have never had so much capital available to deploy with such a range of investment strategies. As such, the market outlook is primed for continued high activity, but perhaps a more targeted hunt for assets despite potential challenges posed by the current market environment.

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