Today, the sale of portfolio companies by one private equity fund to another is becoming increasingly commonplace. When considering a purchaser for a particular company, a private equity fund should include other private equity funds alongside the usual corporate buyer candidates in order to find the best fit. Each category of buyer brings a different set of benefits and burdens to the bargaining table and can offer distinct perspectives to the same transaction.

**Indemnification**

Neither private equity funds nor corporate sellers like to pay indemnification claims. However, they each have different goals when negotiating with the buyer. Corporate sellers are operating companies with future earnings to pay any claims. If the indemnification cap is small, compared to the expected profits of the firm, a private equity fund buyer may be comfortable not insisting on an escrow. In return, the buyer may ask for long survival periods on the representations and warranties. After all, a corporation has perpetual existence.

A private equity fund seller is the opposite. In most limited partnership agreements, the fund is expected to distribute investment proceeds promptly after receipt. This practice also helps their internal rate of returns. Therefore, the buyer knows that most likely the seller will not have cash on hand to pay any indemnification claims. Accordingly, an escrow of some amount of money is necessary. The private equity fund seller, however, needs relatively short survival periods. They do not want to clawback distributions from their limited partners to pay indemnification claims.

A private equity fund seller is the opposite. In most limited partnership agreements, the fund is expected to distribute investment proceeds promptly after receipt. This practice also helps their internal rate of returns. Therefore, the buyer knows that most likely the seller will not have cash on hand to pay any indemnification claims. Accordingly, an escrow of some amount of money is necessary. The private equity fund seller, however, needs relatively short survival periods. They do not want to clawback distributions from their limited partners to pay indemnification claims.

Conventional wisdom also says that private equity funds are less likely to sue their sellers for indemnification claims than corporate buyers since they are more likely to do business with them again. Whether this is true would depend on the particular buyer and the amount of the potential liability.

**Stock Versus Cash**

While private equity funds sometimes employ earnouts and seller notes, they typically buy their portfolio companies for cash. In this way, they are an attractive exit for private equity fund sellers. Corporate buyers, especially public companies, on the other hand, often try to use their stock as currency. This stock is often unregistered (but accompanied by registration rights) and subject to contractual or market practicality selling restrictions. The delay to receiving cash and being able to distribute it to limited partners hurts the funds internal rate of return. In addition, the seller is often not compensated for the inherent risk to holding stock.

**Privacy**

Unless otherwise disclosed by the limited partners in compliance with the limited partnership agreement, sales between private equity funds are private. A corporate buyer, on the other hand, may be subject to state or federal securities disclosure requirements. Therefore, in situations in which the portfolio company has litigation or other embarrassing problems, it may be valuable to sell to another fund.

**Purchase Price**

Private equity funds will often bid for a company as much as they can get financed. Leveraged buy-outs, after all, are the norm for fund buyers. Many corporations are reluctant to incur additional indebtedness. Instead, strategic and corporate buyers prefer to fund their deals in cash or company stock. Further, private equity funds have recently seen an increase in additional capital contributions to their coffers, which has given them ready access to large sums of cash. Therefore, from a financial point of view, private equity funds have the ability to pay more.

Currently, both the private equity and private debt markets are becoming flush with fresh capital from investors seeking the traditionally higher returns that private equity funds can offer. The availability of capital from institutional lending sources, coupled with historically low interest rates, has recently
allowed private equity funds to more heavily leverage their own cash with up to four times the amount of cash contributed to an acquisition out of the fund’s coffers. Private Equity Analyst more recently placed the figure at $106 billion.

After adding the value of all capital contributions to equity funds to the potential leveraged debt that will be used in conjunction with equity funds’ cash for acquiring targets, funds currently being raised represent a staggering potential value of $2.5 trillion in deals worldwide. These readily available sources of capital (both in the form of equity fund cash as well as debt) help form the basis for the prices private equity funds are willing to pay for a portfolio company, as well as impacting an increasing deal flow.

Strategic buyers, however, rarely buy companies because they think they can resell it in three to five years at a profit. They are long-term buyers who see synergies between them and the target. Accordingly, if the fit is right, a target company may immediately be more valuable to a corporate buyer than a financial buyer. This is why private equity funds historically sold mostly to corporations.

Limited Partner Reaction

Limited partners are generally not excited when one private equity fund they invest in sells to another private equity fund they invest in because they have indirectly paid lots of transaction fees but still held the same investment. It also raises a question as to why the first private equity fund sold if there was still value left to be garnered from the portfolio company. Selling to a corporate buyer does not raise these issues. Limited partners assume that the selling fund made the best decision.

One should note that unlike strategic or corporate buyers, many private equity funds have fixed lifetimes. Where one fund may be nearing the end of its investment horizon and looking for exit strategies to lock in its limited partners, other funds may be just beginning to seek out acquisition targets. In the event a private equity firm is attempting to raise a new fund, it typically will need to spend 75%-80% of its commitments. This leads to different funds viewing the same potential target through different lenses. The need to spend this amount of cash with up to four times the amount of cash contributed to an acquisition out of the fund’s coffers. Private Equity Analyst more recently placed the figure at $106 billion.

After adding the value of all capital contributions to equity funds to the potential leveraged debt that will be used in conjunction with equity funds’ cash for acquiring targets, funds currently being raised represent a staggering potential value of $2.5 trillion in deals worldwide. These readily available sources of capital (both in the form of equity fund cash as well as debt) help form the basis for the prices private equity funds are willing to pay for a portfolio company, as well as impacting an increasing deal flow.

Strategic buyers, however, rarely buy companies because they think they can resell it in three to five years at a profit. They are long-term buyers who see synergies between them and the target. Accordingly, if the fit is right, a target company may immediately be more valuable to a corporate buyer than a financial buyer. This is why private equity funds historically sold mostly to corporations.

Limited Partner Reaction

Limited partners are generally not excited when one private equity fund they invest in sells to another private equity fund they invest in because they have indirectly paid lots of transaction fees but still held the same investment. It also raises a question as to why the first private equity fund sold if there was still value left to be garnered from the portfolio company. Selling to a corporate buyer does not raise these issues. Limited partners assume that the selling fund made the best decision.

One should note that unlike strategic or corporate buyers, many private equity funds have fixed lifetimes. Where one fund may be nearing the end of its investment horizon and looking for exit strategies to lock in its limited partners, other funds may be just beginning to seek out acquisition targets. In the event a private equity firm is attempting to raise a new fund, it typically will need to spend 75%-80% of its commitments. This leads to different funds viewing the same potential target through different lenses. The value to each individual fund, depending upon its financial goals (i.e. locking in returns or acquiring new portfolio companies), is at least in part subjective. Understanding this concept is vital for limited partners attempting to rationalize secondary sales in the private equity arena.

Management

Typically, a strategic buyer will replace management wholesale or at least subject them to the authority or vision of the corporate parent. If the portfolio company already has a talented management team, this is a waste of a valuable asset of the private equity fund seller. Fund buyers generally are dependent, at least in the short run, on all or a portion of the management team in place. If the management team is not that exceptional, it will be reflected in the purchase price.

Because management often gets replaced in a strategic sale, the seller’s management team will be less enthusiastic about selling to a corporate buyer than another fund. Hopefully, the employees have a sufficient equity stake in the company that their economic interests are still aligned with the fund seller. Therefore, with the growth of the importance and likelihood of secondary private equity sales, it becomes even more important to think about having management be properly incentivized at the start.

On the other hand, if management had a negative experience being under private equity control, they may be reluctant to sell to another private equity fund. Therefore, it is important to treat your portfolio companies well.

An Industry Study: Health Care

Health care is an industry that many feel warrants additional private equity attention for a number of factors. First, the health care industry is expected to grow at a rate of 7.5% between 2000 and 2010. The industry is estimated at $1.7 trillion currently, and the government believes it will reach $2.7 trillion by 2010. A notable recent transaction is the acquisition by The Blackstone Group of Vanguard Health Systems, Inc. for approximately $1.75 billion. The seller in this transaction was Morgan Stanley Capital Partners - another private equity fund. Vanguard owns and operates 16 acute care hospitals in Chicago, Phoenix, San Antonio and Orange County.

This is but one example of a situation where although it makes financial sense to one fund to sell a particular portfolio company, it also makes financial sense to another to acquire the company. Value is in large part determined by the perspective of the fund after considering such factors as timing, the need to lock in returns for limited partners, hunger for acquisition targets, the availability of relatively cheap capital, and the potential for additional growth despite the selling fund’s desire to divest. In short, the decision to sell a portfolio company does not necessarily indicate that there is no future potential for return on investment.

Conclusion

A large influx of new capital into private equity funds is causing a surge in acquisition activity. As a result, the number of secondary private equity transactions has increased and the average prices being paid for portfolio companies have also increased. Recently, certain industries such as health care, have seen tremendous growth in opportunities, including record deals in terms of both total value and as a multiple of earnings. The limiting factor in the private equity sector lately has been a lack of suitable acquisition targets, rather than a lack of equity investment capital. Secondary private equity transactions are becoming increasingly popular in order to keep up with the appetite for acquisitions, and should be considered by any private equity fund selling a portfolio company.

If you are interested in discussing the issues addressed herein, please contact:

Robert G. Marks 703.712.5061
rmarks@mcguirewoods.com

Barton C. Walker 704.373.8923
bwalker@mcguirewoods.com

This newsletter is intended to provide information of general interest to the public and is not intended to offer legal advice about specific situations or problems. McGuireWoods does not intend to create an attorney-client relationship by offering this information, and anyone’s review of the information shall not be deemed to create such a relationship. You should consult a lawyer if you have a legal matter requiring attention.

© 2006 McGuireWoods LLP