Guest comment

Questions of Control In Deal-by-Deal Financing

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Deal-by-deal financing has been in the private equity news a lot recently and represents a growing trend.

There are a number of reasons for this: fund investment periods being timed out; fundraising being postponed; diversification limits for current funds being reached; and potential investors testing out a sponsor on a one-off basis before committing to a fund.

The economic terms of these arrangements as between the sponsor and investors vary. In some cases, management fee and carry rates are not dissimilar from private equity funds. In others, management fee and carry rates are lower.

The key area of divergence between deal-by-deal financing and committing to funds arises in respect of the investors' ability to exercise control over the portfolio company.

At one end of the spectrum, investors will have a few consent rights over "nuclear" matters, such as material changes to the business plan, key personnel, issuing additional shares or seeking a listing. Investors may, together, also have the power to appoint a single director or observer to the board of the portfolio company.

At the other end of the spectrum, the structure is more akin to a joint venture with investors having equal power as the sponsor.

In all cases, investors require a much greater degree of transparency and will expect to see all financial information on the portfolio company that is produced for the sponsor.

The structure of deal-by-deal financing also varies. Often, instead of pooling investors and management into a single vehicle or "topco", a separate feeder vehicle will be established for investors for a number of reasons. First, in an effort to keep investors away from negotiations with the sellers and the management team. Second, because the carried interest is best "housed" in a separate vehicle (the alternative would be for the sponsor to hold a special share in topco that simulates the economics). Third, to ease the process when it comes to selling the portfolio company.

Where a feeder vehicle is used, it is generally structured as a tax transparent vehicle such as a limited partnership or limited liability partnership. Sponsors will favour a limited partnership because it envisages a single sponsor (as general partner and manager) with "silent investors".

One of the most contentious issues we have seen as between investors is how to address the possibility the portfolio company may require additional finance from its shareholders.

Investors will want the threshold for approving this consent to be low so they can be sure there will be no blockage on supporting the investment in the event it needs help.

At the same time, investors and the sponsor will not want their stake in the feeder vehicle to be diluted by the other investors. The investors may also want the power to determine the form of the follow-on investment so that the power cannot be exercised by the sponsor, in effect, to block the provision of additional finance.

While deal-by-deal financing gives investors more control over, and visibility on, the underlying assets, investors may lose rights on the key man provisions and governance aspects of the feeder vehicle itself. The "stickiness" of a management team also remains a concern for some investors: will they stick around long enough to manage the asset? A deal-by-deal arrangement may not be enough alone to hold a team together for three to four years.

It looks like this "interim" solution of deal-by-deal financing will become more prevalent and last several years to come.