

PE Firms Finding New Partners As Club Deals Climb

By **Chelsea Naso**

Law360 (March 13, 2019, 3:25 PM EDT) -- More private equity firms are spicing up club deals by teaming up with sovereign wealth funds and pension funds that previously played mostly in the limited partner pool, but the updated take on the deal structure comes with its own unique set of risks.

Club deals — transactions that see more than one private equity firm join forces to buy out an asset — are again on the rise as private equity buyers with record levels of dry powder navigate a mergers and acquisitions environment characterized by a limited number of targets, high valuations, geopolitical headwinds and a tightening of the debt markets.

But private equity firms are not the only investment platform dealing with growing cash piles in a tricky deals environment. Sovereign wealth funds and pension funds are also hunting for ways to put their capital to work and diversify their holdings, providing an opportunity for a fresh mix of buyer groups.

"A lot of these players have been part of the private equity community for many years, but as LPs," said Kevin Schmidt, a Debevoise & Plimpton LLP private equity partner. "They see an opportunity to come into and be involved in the market in a different way."

The Trend

The growing number of club deals stems from a confluence of factors that are forcing both private equity firms and LPs think outside the box for their investments.

"The scarcity of good, available assets and a slight tightening in the credit markets have required buyers to get more creative in how they structure and execute deals," said Garrett Charon, a Ropes & Gray LLP private equity partner.

Buyers are dealing with higher target valuations amid a dwindling pool of attractive assets and shifts in the debt market. For funds, the environment is even more challenging as they try to compete for those targets with strategic corporate buyers who can justify higher multiples due to anticipated synergies and can use stock to help finance a deal.

And although private equity firms are sitting on a record \$1.2 trillion in dry powder, a club deal can help make sure a single fund is not overcommitting to a single asset.

"That requires larger equity checks. And when you have larger equity checks, that often will lead to private equity sponsors teaming up together so the aggregate size of their check isn't so large in comparison to the size of their fund. So they're not effectively overconcentrated on one investment," Charon said.

But it's not just the private equity firms that are benefiting from the arrangement. It also gives pension funds and sovereign wealth funds more control over their investments, more direct access to new industries or geographies, and serve to reduce the fees they sometimes see.

"Over the last couple of years, we've been seeing these types of deals with increasing frequency. A lot of times LPs join with GPs, which gives LPs a great opportunity to get more involved in the deal, and for GPs, it makes a lot of sense because it helps share the risk among a broader group," said Amy Wollensack, co-chair of Covington & Burling LLP's private equity practice.

"For non-U.S. traditional LPs, co-investing — whether it's a GP of a fund you are investing in, or just another PE fund — is a great way to break into the U.S. market," Wollensack added.

The Challenges

While the deal structure is attractive for a number of reasons, it also comes with its fair share of challenges.

A private equity firm that is used to acting quickly will need to take the time at the outset to ensure that each fund in the buyer group is on the same page about the transaction.

"It just puts a greater importance of having that alignment early on," Schmidt said.

That includes agreeing on details pertaining to the terms of the buyout offer, the planned governance of the asset once it is acquired, the approach to enhancing the business, and the anticipated investment horizon.

"Private equity sponsors in particular, the large cap sponsors, are used to doing deals on their own and the private equity decision-making process is very streamlined," Charon said. "That creates some complications in terms of governance of the portfolio company and in terms of negotiating the deal terms. That requires advanced planning to make sure there is a firm business understanding of how the two sponsors will operate together."

It's more than just fine-tuning the operations of the business. Before the deal is inked, it also needs to be clear to each member of the buyer group exactly how the how the eventual exit from the investment will be handled.

"You spend a lot of time talking about and negotiating exit provisions — when do you go public? Can you sell down? What happens to your governance rights when you start to sell down?" said Sergio Urias, co-chair of Covington & Burling's private equity practice. "The structuring around how you are going to exit the investment is key and sometimes challenging."

Buyers also need to take into account that certain pairings may come with heightened regulatory scrutiny. That means considering potential antitrust issues but also evaluating any potential challenges from the Committee on Foreign Investment in the United States, which reviews certain transactions involved foreign buyers for national security concerns.

CFIUS was overhauled last year through the Foreign Investment Risk Review Modernization Act. FIRRMA gave the CFIUS the ability to review noncontrol investments by foreign entities in companies in the critical infrastructure or technology spaces, or those that hold personal data of U.S. citizens.

The legislation also explicitly opened the door for the committee to review other investments that give a foreign person influence over a U.S. entity or access to nonpublic information, such as the right to be on the board, nominate a board member or even just observe the board.

"Today you need to be mindful of the heightened attention CFIUS is getting, including the more recent enactment of FIRRMA," Schmidt said.

--Editing by Katherine Rautenberg.