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Private Equity Bulletin

TO CLUB OR NOT TO CLUB: IT'S NOT JUST FOR THE YOUNG ANYMORE

"Gone are the days when buy-out firms fought each other with the ferocity of cornered cats to win deals"[1]

In its most basic form a "club deal" is simply a consortium of private equity funds that work in a collaborative nature with one another to accomplish one goal - to jointly acquire a target that would otherwise be unobtainable. The structure of a club deal, while not a recent phenomenon, has been sparingly used since its infancy. That said, since 2004, club deals have become increasingly prevalent in the mergers and acquisition sector. In fact, in 2005 alone, United States-based private equity funds made investments of almost $200 billion, of which over half of such dollar amount was directly representative of club deals. Furthermore, from what we have witnessed so far in the first two quarters of 2006 the upward trend of club deals shows no sign of slowing down, and for good reason. While club deals are inherently saddled with certain drawbacks, they provide funds with tremendous opportunities for return on investment and other major benefits to target companies and funds alike.

Benefits of Doing a Club Deal

The rise in popularity of club deals is due in large part to the following factors:

Increase in Deal Size

Over the past several years, overall transaction sizes have risen significantly due to divestitures of large business units by corporate conglomerates. To take advantage of these opportunities, funds were required to come together to form "partnerships." The reason: it has become clear that most funds do not have sufficient resources to put enough equity into such a deal. In most instances, even if sufficient funding was available, the governing documents of many funds contain diversification requirements that limit the amount of a fund's assets that can be invested in a single investment.

Access to Financing

A club deal also provides funds the ability to pool their business relationships and contacts with potential financing sources. The pooling of such resources enhances the degree of certainty that the financing will be available come closing. Moreover, the club, as a whole, is able to benefit by leveraging such relationships in order to obtain financing on more favorable terms than otherwise would likely be available in a single fund transaction.

Expertise

In the past, it was not uncommon for each fund to strictly protect its individual investment strategies. In club deals, funds amalgamate their respective resources and strategies, which, in turn, enhance the prospects of being the winning bidder. A club with specialized industry expertise and/or knowledge of the local business landscape brings with it certain intangibles that may be attractive to the management team of a target business.

Disadvantages of Doing a Club Deal

While the structure of a club deal provides funds with a surfeit of enticing benefits, there are also pitfalls that may accompany such deals. Failure to heed these pitfalls may have deleterious consequences not only on the club but also on the overall transaction. The most sensitive issues facing club members are the numerous internal organizational, legal, and strategic considerations, which are not otherwise present (or only to a lesser degree) in single fund deals. In most cases, a club deal will require different governance provisions among the funds, which may well limit the ability of an individual fund to exert control over the target and/or influence the ultimate exit strategy of the club.

Bid Conduct

Each member of a club needs to balance its overall goals and desires against the need for a streamlined process. Although the club will usually designate one investor with primary negotiation authority, there are times when different investors will need to take the lead role on discreet aspects of the overall transaction (e.g., acquisition, management arrangements, financing, diligence). This allocation of responsibility, although time-consuming and potentially more costly, may be more effective than if exercised by any one fund alone.

<u>Organizational Issues</u>

Club members may become wary of hiring the traditional advisor of one investor to lead negotiations. This concern stems from the notion that prior allegiances will prove paramount and that neutrality will be at best a "legal fiction." However, finding a "neutral" advisor with the knowledge and experience of club deal transactions may provide difficult. Accordingly, each investor will likely require separate counsel to negotiate on its behalf.

<u>Governance, Exit and Post-Closing Matters</u>

In a transaction involving an investor consortium, the stockholders agreement is an important part in outlining the relative rights of each investor post-closing. Governance arrangements are shaped by a variety of factors, including, but not limited to, bargaining position, expertise pertaining to the target business, and, most importantly, each investor's respective equity stake. The litany of material internal governance issues may include:

Approval Rights

Most funds that control transactions are generally accustomed to having control of the portfolio company following the consummation of the acquisition. In transactions that are funded by a single investor, such investor is also accustomed to controlling the blocking rights that investors have. Sharing these rights may be distressing as well as cumbersome and each investor must reign in their desire to exercise ultimate control over the company for the betterment and on-going financial health of the company post-closing.

Board Representation

Club members will need to reach agreement on the number of available board seats, replacement procedures and other related provisions in order to account for adjustments in representation upon a change in ownership positions.

These issues, in addition to issues relating to transfer restrictions, anti-dilution protection, and allocation of transaction fees, are generally a contentious process unless all of the members have an equal percentage of the deal and, therefore, have equal rights and obligations. Notwithstanding, even with an equal playing field such a structure may diminish the ability of members to add value to a transaction by restricting each member from being able to make decisive and bold business decisions.

<u>Demands on Personnel of Target</u>

Funds have long been known for engaging in extensive due diligence before consummating a transaction. In the realm of club deals, this means that a target may have to entertain multiple requests from multiple sources. These requests can create over-reaching demands on a management team and other personnel, which will often require such individuals to focus on supplying members of a club with abundant and detailed information rather than running a business.

Partners in club deals face unique challenges and considerations. The key to a successful "marriage" is a common agreement on future vision, values and directives, while at the same time being flexible enough to deal with differences and trying economic times. Following these strictures will ensure that the recent influx of club deals are not a flash in the pan but a stalwart in the private

Additional Information

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1 The Economist, London, April 2, 2005, Vol. 375, pg. 72.