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Roundtable

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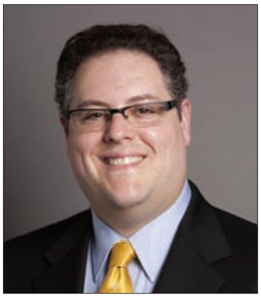
David J. Blair
PNC Mezzanine Capital


Michael Frankel
LexisNexis


Michael S. Goldman
TM Capital


James M. Hill
Benesch Friedlander Coplan & Aronoff


S. Scott Isherwood
Morgan Joseph & Co.


Mark Sullivan
Lineage Capital


Ken MacFadyen
Mergers & Acquisitions

Not pictured:
John Sinnenberg
Key Principal Partners

Dealmakers convene to discuss the intricacies of staying in control of non-control deals

Photographs by Dan Nelken

Traditional M&A has experienced little in the way of a recovery. Minority stake deals, as a result, have intrigued both buyers and sellers as a compromise that allows investors to put money to work, while business owners can achieve liquidity and help fund further growth. Non-control deals, however, come with a number of traps for those not used to sitting shot-gun and sellers, at the same time, may be surprised when their new partners aren't the passive investors they envisioned when they sold sold off the 30% stake. Still, those active in the segment proselytize about the opportunity, claiming that on a risk-adjusted basis, non-control investments represent the most attractive area in the market today.

Mergers & Acquisitions brought together top dealmakers in the segment in July, representing private equity, mezzanine, and strategic investors, as well as bankers and lawyers well versed on the complex structures these transactions tend to take on. Taking part were PNC Mezzanine Capital's David Blair; Michael Frankel, of LexisNexis, representing the strategic perspective; TM Capital's Michael Goldman and Morgan Joseph & Co.'s Scott Isherwood; private equity investors Mark Sullivan, of Lineage Capital, and Key Principal Partners' John Sinnenberg; and James M. Hill, partner and the executive chairman of law firm Benesch Friedlander Coplan & Aronoff, where he also chairs the firm's PE practice.

The following is an edited version of the two-and-half hour conversation.

"I'd prefer if the people who really aren't interested in the non-control deals would just go away."

David J. Blair
Partner
PNC Mezzanine Capital

Mergers & Acquisitions: *Anecdotally, we've been seeing a lot more minority-stake deals over the past 18 months, or at least the percentages seem higher in terms of the total deal volume. What is driving this activity?*

Isherwood: Generally speaking, minority investments are harder to find for sellers. I'd say that 80% of the private equity funds out there can't even look at anything but a majority-stake purchase.

Hill: It's not in their charters.

Isherwood: So it can be difficult from that perspective. At the same time, you're probably seeing relatively more minority-stake investments that are a result of the current lending environment, deals that would fall into the growth capital category.

In some cases, you'll also see a situation where somebody might be looking to take out an older partner who hasn't been involved over the past few years, but usually it's about finding capital to fund growth.

Hill: In my own experience, we're seeing a lot of situations where business owners don't want to sell the whole company at what might be considered depressed valuations; a non-control deal allows them to take some chips off the table and at the same time

> **The value of that commercial relationship can totally eclipse the value of the equity investment.**
> Michael Frankel
> SVP, Business Development / M&A
> LexisNexis

fund growth. We've worked on four or five of these types of deals over the past year and a half, and in most cases it was a combination of the two drivers.

Sullivan: I probably have a slightly different take on this since our model at Lineage Capital revolves around non-control deals. We've made nine investments; in seven of them, we own 60% or more of the company, but control still resides with the original owners. In all of the cases, it was about the owners taking chips off of the table. There was no growth capital; we seek out businesses whose cash flow can fund growth. This year, we've also witnessed owners looking to gain some liquidity ahead of changes to the capital gains tax rate.

Goldman: A lot of it is a function of what stage people are at in their careers. If you're talking about a business owner nearing retirement, this type of deal may not be a fit. If they've hit a mid point in their careers, where you have a management team that wants to take a business to the next level but doesn't want to cash out completely -- especially when valuations are depressed -- then these deals are a compelling alternative. Liquidity may be a factor in their thinking, but a lot of businesses are seeking a partner who will help them improve and grow their company.

Sullivan: We had a recent deal in which the founder remained a 51% owner of the company. This was a roughly $49-million-a-year business at the time. She told us directly, "I know how to get to $50 million; but I need someone to help me get to $100 million." She wasn't looking to retire or cash out. She was looking for a partner who could help her take the business further than she could otherwise do on her own.

Mergers & Acquisitions: *Which company was this?*

Sullivan: It's a gift manufacturer called Mud Pie.

Sinnenberg: I think a key word you'll hear when discussing non-control is the term 'partner.' I'd argue that a lot us, if not all of us, only want to work with companies where the owners and management view us as a partner as opposed to just 'the money.'

It doesn't matter what kind of deal it is. Whether it's a recap, a PIPE, acquisition capital, if there's no collateral and the owners want you to share that risk, you have to find a certain connection with the management. When you're not a controlling shareholder, you have to team up with managers who view you as a partner and want to share their problems with you as they come.

Sullivan: The key for us is figuring out who really does want to partner with us.

Blair: There can be a difference between how they feel about it when you close the deal and then how they feel about it three years later. There is initially this joy and euphoria. I'll tell folks to remember that period, because in about two-and-a-half years they're going to wonder why I own 40% of their business.

We're working on a transaction right now where they could have found a buyer, but management wants to do more with the company. We put a recap on the table that allows them to take a little bit off and focus on growing the business. Their primary concern was what we were bringing to the table. It's a privately owned business, so they are essentially looking to pretty themselves up for the next sale and wanted to be sure we could help toward that goal.

Sullivan: We'll actually call ourselves the bridge to the next sale.

Hill: It's interesting because for a couple of recent deals, we represented the company and not the fund. The greatest concern on the part of the sellers was the nature of the partnership. The valuation was important, but they prioritized factors like industry expertise and a firm's network.

Mergers & Acquisitions: *I think the consensus agrees that the broader deal market seems to be perking up. Are minority-stake deals a phenomenon of the dislocation? And if so, is it expected that dealflow will shrink as the M&A market improves?*

Hill: There will always be a place for minority-stake deals. My own personal view is that as long as buyers have experience with them, they'll always present an opportunity to invest in mature companies that otherwise would not be open to a traditional sale. It's actually an under-served market, and I think there's a misunderstanding on the part of sellers about what a non-control investment can do for a company.

Frankel: My view of the market is similar to Jim's. The M&A landscape, in general, is a very twitchy market right now.

On the corporate side, everyone is poking their heads up, canvassing what's out there. As it relates to minority-investments, there's a pent-up demand from companies seeking interesting segments and new drivers of growth. Corporates are coming out of the woodwork to make up for a two-year period that saw very little innovation. But their filters are still incredibly high, and there has to be a perfect fit for the company before they'll be ready to commit to an investment.

Mergers & Acquisitions: *Coming from the corporate side, can you talk a bit about how deal flow may be different than something John, David or Mark might come across?*

Frankel: I tend to come across much smaller, earlier stage companies. These mid-stage businesses I encounter usually aren't looking to take chips off the table. For the most part, they're usually doing pretty well, so the cash flow can sustain them. If they're looking to sell a minority stake, it's about funding the growth or finding a strategic partner that can help them reach a new plateau. In fact, they'll often come to us and ask, "What's the least amount I sell and still make you a partner." What they're looking for, perhaps even more than the money, is your brand and your sales force behind them.

"In certain markets, there may be a perceived discount that comes with a minority-stake investment."

Michael S. Goldman
Managing Director
TM Capital

The exception, though, involves earlier-stage companies where there may not be sustainable cash flow, and you have a founder who has been in it for three to four years. They may have held off taking money for the first few years, but over the past 18 months they've been in the desert. They're at a point now, where they may be thinking about their mortgage, so they'll be willing to take some money out of the business.

Sullivan: You'll see that at the lower end of the middle market too. Occasionally, the owners will have personal guarantees on a company's loans, and they'll look for a deal to help get them out from under those.

Mergers & Acquisitions: *I alluded to this earlier, but generally speaking, would these minority stake deals be control transactions in a better market?*

Goldman: Different markets produce different transactions. In a difficult market, the minority-recap model fits very well. The owner may be a little more risk averse, but at the same time the business isn't performing as well and multiples aren't as high as sellers would like, so it comes down to the question of how you balance those different goals.

These days, the market has improved. It's not 2007, but on a going-forward basis, I think the minority recap is going to face some tougher competition, be it from majority recapitalizations or straight sales. With that said, there is always a market for these deals.

"When you create so many metrics as a minority investor it can create its own set of problems."

James M. Hill
Partner and
Executive Chairman
Benesch Friedlander
Coplan & Aronoff

Sinnenberg: I would offer the observation that the whole market is set up for the change-of-control deals because they're a better driver of investment banking fee income. The difference between a $100 million control deal versus a $15 million minority-stake recap is pretty significant if you're judging solely by the fees generated.

I've found that a lot of intermediaries won't mention the non-control option until the client actually says that they don't want to sell control. At that point they'll take the minority deal out of their back pocket, arm the seller with some information, and try to get some money out of it until the client is willing to go all the way.

Blair: When we market ourselves to investment banks, we'll tell them to think of us as an extra tool in the kit. We've gotten some really nice deals out of it. They'll run a process for three or four months, and the owner is being told they'll have to roll 40% of their stake into a potential sale and still have to report to a board filled with a bunch of private equity guys.

Hill: Plus, their 40% stake is going to carry more leverage than it used to, so they're facing significantly more risk.

Blair: Right. And at end of day, it just doesn't feel right. If minority equity or mezzanine funding gets them 50% of the capital that they were going to get by selling control, and they're not nearly as diluted, that can help business owners get over the hump.

Frankel: We've already touched upon it, but there is a fundamental difference between selling a minority stake because the seller wants a true 'partner' versus selling a business in chunks because they don't like the valuations they're seeing. My gut says the latter pool of transactions shrinks as the market improves, but the 'partner' deals will always be there, and maybe even moreso in a hot market; it's these environments where business owners realize that they need help or a certain level of expertise to take advantage of the opportunity.

Sinnenberg: In terms of our experience, from late 2006 to early 2008, it was very hard to get anybody's attention for a non-control deal.

Hill: The multiples were too high.

Sinnenberg: And we couldn't disagree with them.

Blair: In this current market, I'd actually prefer if the people who really aren't interested in the non-control deals would just go away. We've had visits from all these folks who don't have anywhere else to put their capital, and they're coming in saying, 'I never would have done this before.'

Frankel: I'm curious, though, how illusory is that line between control and non-control? If you own 40% of a company and you don't have 'control' per se, but you sit on the board and engage with the CEO, do you really have that much less of an influence than the LBO firm with a 70% stake, who may or may not be actively involved day to day?

Sinnenberg: I think there is a big difference, actually. If the company is having problems, when you have control you can go in and replace the CEO.

Hill: When you don't, it takes three to six months of diplomacy, and you'll have to rely on covenant violations to get the management to the table to discuss possible changes. That can be a huge difference. That's why non-control deals need to have less leverage, so you can keep the senior lenders at bay while you try to fix the business.

Frankel: In a troubled scenario, it's more evident. But does the difference between control and non-control start to disappear in a better situation?

Hill: I think the difference is psychological in some ways. Most minority-stake investors are still going into a deal with certain approval rights. They're not going to allow the majority ownership to just go off on an acquisition spree and incur a lot of debt or issue new equity. There are certain approval rights at the shareholder level. Having said that, psychologically, it seems to make a difference for the owner/operators, who view the investors in an advisory or partnership role. They understand that investors have certain veto rights, but it's a lot different than walking in knowing the sponsors have full control.

Sullivan: For us, it's a little bit dependent on what part of the market you're in. When we're investing in a

business with between $4 million and $10 million of Ebitda, it's likely that a CEO will have certain client relationships or have some similar hold on the business that would prevent a control investor from wanting to move too quickly.

Generally speaking, though, I agree with what Jim said. If you're muddling along, and the business is growing at maybe three percent when we believe it should be closer to 10% or 15%, then it's going to take six to 10 months to convince management that a change has to be made.

Mergers & Acquisitions: *I want to discuss the some of the structures used to facilitate those conversations and add protection. First, though, I wanted to circle back to discuss how the approaching refinancing cliff is driving dealflow. Has there been a supply of overleveraged companies reaching out to minority stake investors for an equity cure?*

Sinnenberg: We haven't really seen it, at least not for companies in the sub-$15-million-Ebitda market. We've been pretty disappointed because we had expectations that we would.

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we've always been taught there's a control premium but in practice it's hard to see.

S. Scott Isherwood
Managing Director
Morgan Joseph & Co.

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Hill: Part of it goes back to the banks just 'kicking the can.'

Goldman: On top of that, I think we have also seen some recovery in the markets. And slowly but surely, as the economy has been improving, companies are finding more alternatives in terms of strategic transactions that yield an ultimate exit.

Sinnenberg: Another factor that I think played a role is it became very unpopular, politically, for the TARP-funded banks to try to force companies to take on capital.

"It's going to take six to 10 months to convince management that a change has to be made."
Mark Sullivan
Partner
Lineage Capital

Mergers & Acquisitions: *Getting back to some of the technical considerations in these non-control deals, how much say do you get from Day One? Do you have control on how your money is being used?*

Hill: My experience is that it's discussed pretty thoroughly from the start. You won't see a firm like KPP make a $30 million investment in a company and a few weeks later, the CEO goes out and makes an acquisition without talking about it with John. It's pretty carefully demarcated from the start.

Isherwood: We're currently going through one negotiation on a minority investment, and in addition to being on the board, the investors have to approve any new issuance of securities. Of course, that's pretty standard. But the board representative is also going to be sitting on the compensation committee and on the key-hire committee, so they'll have a say on how the capital is spent right down to whether or not the company can hire a senior vice president.

Goldman: I usually find that it's the company that starts with a vision of how they're going to grow, and then the partner comes in and helps fulfill that plan. If all the company wants is some flexibility and liquidity, they can secure an extended bank line or some other low-cost financing. The capital around this table, though, is further up on the capital structure and more expensive. If companies are going to take on that dilution, they're already looking to do things they otherwise wouldn't be able to.

Sullivan: We'll typically have documentation that acts just like a bank loan. Basically the management can spend up to a certain amount without our input, at which point certain stipulations may serve as a guide post.

By and large, I think if you're picking the right partners, they'll feel an obligation to involve you in the decision making. We picked the wrong person once and he didn't feel obliged about anything, but if you pick the right one, they'll get it.

Frankel: You probably have much more influence at the initial stages of the deal. It's all going to be contractual. It gets harder and harder and there is more opportunity for interpretation as time goes on.

From the strategic perspective, everyone may agree upfront that the capital is going to be used to develop 'product X.' Over time, how you implement that and where you spend the money, that's where the gap may occur between your investment thesis and management's plan. And no matter how tightly you set it up at the beginning, the market is going to dictate changes as you go along.

Sinnenberg: When we put our money in, except for growth capital, we know where it's going. The question, though, is what do they do with the cash flow?

Blair: By year two or three, 'the money' is just the money that's coming out of the business.

Hill: As part of the initial discussion, there has to be some education for management, so they don't go into it thinking that they're going to take the money, and the investors are going sit on the sidelines, completely passive. I've been in situations where, candidly, I've had to counsel the client on what to expect. We brought in some qualified investors and when the discussion moved to the approval rights, they didn't want to consider anything that was being laid out in front of them. I had already been over it with them three times, but they were still asking, 'So what if we want to issue more debt?'

The education process doesn't have to be difficult. It's about explaining that the investors have their own limited partners to answer to; they have fiduciary duties to uphold; and they also need to generate a return on the investment. If management can't get their arms around this, then they shouldn't be in the market for this kind of transaction.

Frankel: One wrinkle I'd add on the corporate side is that when a commercial relationship is involved there is usually an added obligation beyond just the capital invested. The smaller company may ask why they're putting money into something if the investor hasn't been adding their resources, whether it's sales efforts or marketing. It's an added complication, because they can debate the original goal of the deal.

Mergers & Acquisitions: *In terms of valuations, is there a premium for control? And if so, what is the discount for a minority-stake position?*

Blair: I don't think we receive any discount. It's really no different than anybody who puts a value on a business. It's all relative to our view of where the company is and where we think it's going to go.

Goldman: In a way, it's a function of market conditions. In certain markets, where control buyers don't step up, there may be a perceived discount that comes with a minority-stake investment. There may be some discounts that apply, but they're not as large as most clients tend to perceive at the beginning of the process. Equity is very competitive in general.

Sullivan: The discount may apply when someone decides that they really want to work with you. I'm not saying that we won't ever be the highest bidder, I'm sure we are, but in cases in which we've been told by the bankers that the sellers wanted to work with us, I'd guess that the gap ranges from five to 10 percent.

Hill: It's very tough to measure, though.

Isherwood: It is. Theoretically, we've always been taught there's a control premium but in practice it's hard to see. You rarely come across a situation in which a seller has a choice between taking a 30% or a 60% investment, valued at either X or Y. Absent that, it's tough to figure out.

Sinnenberg: When we talk about valuations, the biggest difference between the control and the non-control deal is the risk-adjusted return, and I don't think a lot of people in the traditional private equity world really look at deals with that mindset.

Mergers & Acquisitions: *What are your return expectations? Is it in line with the 20% to 30% IRR traditional private equity investors say they target?*

Sinnenberg: It depends on the security. If I was doing a non-control mezz with a preferred piece, for a company with north of $10 million Ebitda and leveraged somewhere under four times, I'd be quite happy somewhere between 17% and 20 percent.

> **"The difference between a $100 million control deal versus a $15 million recap is significant if you're judging solely by the fees."**
>
> John Sinnenberg
> Managing Partner
> Key Principal Partners

Goldman: Would you share that deal with us?

Sinnenberg: We're closing one tomorrow just like it.

Blair: I can see that. You've got the current pay rate from Day One, so you're already starting to monetize your investment at the closing. Then you have all the market value below you, so on a risk-adjusted basis, if you're up there on the balance sheet, 17% to 20% makes sense. I'd add that I don't know too many LBO guys getting 30% right now either.

Sinnenberg: There's so much change-of-control capital out there that they're looking at between 15% and maybe the low-25% range. With the mezz that we're doing and the preferred shares, we're more in the 16% to 19% IRR range. When you consider the difference in leverage, on a risk-adjusted basis the non-control deals are going to outperform over the next several years.

Mergers & Acquisitions: *Mike, from your perspective as a strategic, how do you measure returns if you're investing around a commercial relationship or with an eye toward a future acquisition?*

Frankel: It's a multi-layered analysis, which makes it a little tough. We will do the IRR or ROI analytical work on our equity, and we have to be able to forecast a decent return on capital in that sense, but corporates, in general, have other considerations. Because of that, the targeted return on invested capital may not be as high as financial investors and most are probably happy if they can get a return that breaks 10 percent.

What's harder to calculate, and frankly the reason corporates usually pursue minority deals in the first place, are the commercial benefits. It's sort of the tail wagging the dog, but it can be about planting something in the ground to acquire it later on. In that case, I'd actually argue that the savings from having that stake isn't always as powerful as the investors originally believe. Usually, corporate investors want to have a leg up on the market when the bankers are brought in. Even if we don't have the legal right of first refusal, if we're in bed with the company, the thinking is that they'll come to us first. Another component is just the market intelligence you can gain; I'm not sure you can put a value on that. And, obviously, a key consideration is the stand-alone commercial relationship that's literally driving P&L dollars. This is usually the part that makes corporate venture valuations a little screwy, because the value of that commercial relationship can totally eclipse the value of the equity investment. I've been in situations where in private we'll say it doesn't matter if an investment goes to zero, because if the commercial relationship stays in place for at least three years, the dollars that are pulled through the P&L turn it into a home run.

If a financial sponsor is investing alongside a corporate, though, it creates some very weird dynamics. The strategics have all these other benefits that a pure investor doesn't get.

Mergers & Acquisitions: *Jim, I'd be curious to get your point of view on some of the drawbacks of negotiating a right of first refusal?*

Hill: The right of first refusal is an important consideration, but it will usually create some issues. To extend Michael's point, if you're a financial investor alongside a strategic, the right of first refusal instantly reduces the market size of the target business. You also have the issue, if you're a financial partner operating with a timeline, that the strategic may wind up going in a totally separate direction that may not even consider an exit.

Frankel: I think that's right. The flip side to that is if the strategic partner can bring the business some major commercial value, then the financial partners may love it.

Goldman: From a banker's perspective, even if there is no right of first refusal, the perception when you go to market is that if Intel owns 25%, they'll have an inside track.

Frankel: That's why I've always been a little surprised by how much value people put on the right of first refusal. If they're well drafted, I'll almost think of them as non-binding LOIs. But if I'm on the board, I'm going to know that the company is thinking about selling. It gives me a window of opportunity, so I never understood why people fight so hard over that legal right.

Hill: As a strategic too, you have so many relationships that put you in an entirely different position.

Frankel: That's right. Sometimes the most powerful link you have is through the commercial relationship. If you can bind a significant chunk of the revenue to that connection than any other buyer is going to have trouble working around that.

It's worth noting that a lot of strategic investments are completed with zero intent to buy the business. I've often done deals in which I'm interested in locking up the commercial relationship, and the business doesn't involve any competitors so that relationship is viewed as a positive by potential buyers.

Sinnenberg: Michael, I'd be curious, at the onset of a deal, how clear are your goals to the target company?

Frankel: It depends on the situation, but I think it's relatively clear in most cases. You can also tell by the nature of the commercial relationship whether the investor sees the market as an area they want to pursue down the road or if they're just filling a gap so they don't have to use internal resources to cover a segment.

Hill: We've seen a lot of these deals where financial buyers team up with strategics to acquire a company. We've worked on a couple and they're pretty complex because you have to understand the strategy of each party involved and their end game. Occasionally, it seems like a great idea for financial partners because they think they're getting all this great expertise, but you often reach a point where the parties ask themselves, 'If we put more into this business, who does it benefit?'

The other question revolves around the logical buyer for the asset. Things change over time, so you can't make any assumptions.

Frankel: I'd also just note there is a huge difference between a corporate entity making a strategic investment and a commitment from a corporate-run venture fund. In the latter case, most true funds are operated much like a traditional investment vehicle. Strategic investments, though, are usually overseen by the corporate development executives or even the line manager. They're totally different creatures.

Mergers & Acquisitions: *Success in most cases seems to go back to the alignment of interests. How do you make sure interests stay aligned and what mechanisms do you have at your disposal to protect you? For instance, the investment thesis behind most minority deals centers around a holding period that extends at least a couple of years. What do you do if the company wants to sell, especially at a valuation that is less than compelling?*

Blair: For us, and this may be different for others, we structure our deals with debt, so we're usually counting on receiving that coupon for at least a couple of years. We actually had a deal a few years ago, in which we spent eight months getting into the investment and within nine months were out of it. As soon as we issued the press release, the biggest strategic player in their industry starting pinging the CEO. They ultimately offered our year-five equity value and a deal was made. The internal rate of return for us was fabulous, but you can't spend IRR. We made about 1.6x our money, which isn't bad, but we thought we would be going in with the same equity gain, plus a four-year hold with a 12% coupon. You can't deny someone from selling the company, but we would have preferred the latter scenario.

Goldman: But isn't the greater challenge a situation in which the time is approaching for an exit, but for whatever reason, the management team that has control isn't as interested in pursuing a transaction?

Sullivan: For us, it varies a little bit. We typically agree that for the first three or four years, we can't force a sale. So if they wanted to build the business, create some value, whatever their needs may be, they'll at least have some runway to do that.

We've also come across situations in which all of the other shareholders were in favor of a sale, but the largest shareholder didn't want to sell. We pulled him along, and he was pretty happy with the decision after the industry crashed a couple of years later. But every once in a while, you'll get someone that really falls in love with their business. Occasionally, we'll see fit to negotiate a right of first refusal. It's usually the case that people think they'll want to buy the business back and run it forever, but they usually change their mind.

Blair: More often than not, it's management that has led us to the exit. We're much more patient as an investor if we're getting our 12% to 14% a year.

Hill: I've been involved in several deals over the years where for whatever reason, management wasn't interested in a sale. In those cases, we've been able to facilitate an exit through a recap that brings in a new minority investor.

Sinnenberg: You always run the risk of getting taken out early in what appears to be a successful transaction. That's just one of the risks of the business we're in. But we'll usually have an option to buy the company in a case where we think the business is being run sub-optimally.

Sullivan: Have you ever exercised that option?

Sinnenberg: Yes. The owner's son-in-law was put in charge of the day-to-day operations, and he knew that we didn't see eye to eye. The son-in-law went off and agreed to sell the company at an absurd price, so we stepped up, and paid a million more. We still own it today.

Hill: John, if you're guaranteed a certain cash-on-cash return, are you willing to be dragged along in a deal?

Sinnenberg: Well, we're willing to be dragged along, period. It's just a right that most get.

The rights change the closer you get to 50%, but if we own 30% or less, we're just going to get dragged along, regardless. We don't really have a choice.

Hill: We've seen a lot of East Coast firms that are willing to be dragged along at a certain cash-on-cash return. The metrics change over the life of the investment, but they have veto rights if the return doesn't reach a certain threshold.

Blair: So they want three-and-a-half to four times their money, whatever it is, year one, year two, et cetera?

Hill: Exactly.

Sinnenberg: Are those typically control firms stepping down?

Hill: No, they're non-control firms.

Mergers & Acquisitions: *It's tough to generalize when you're talking about non-control deals, but what's a typical capital structure look like and what protections can be put in place for the investors?*

Hill: Generally speaking, the capital structure would typically be comprised of a convertible preferred with a PIK, with 'put' rights five years out. A PIK today could be anywhere from eight percent to 12 percent. The put rights, I'd add, can be fun in theory but in practice don't always do you much good.

One of the key things you have at your disposal at the director level is approval rights. It's a negotiated section, and if you do a lot of these deals you have a pretty good sense of what is considered 'market' versus what might be considered micro managing.

It can also get pretty technical. If you're going to structure a waterfall, you have to think through how that works with an LLC and how it is impacted by a tag along. You can also run into complications if the target company goes public; in which case you need to map out how that affects your preferred units and how it all gets converted. We've seen instances where the sponsors hadn't thought these things through and it cost them a lot of money.

The major issues, though, really revolve around your approval rights. Most investors back a deal because they believe in the management team and they go into it trusting that they'll have a good relationship. With that said, when you invest $20 million, $30 million, $40 million into a business and you don't have control, you have to make sure that you're on the same page with the owners.

Isherwood: You have to have that downside protection.

Mergers & Acquisitions: *Regarding the 'puts,' why are those only good in theory?*

Hill: It's just very rare to see it used.

Blair: We've never exercised it.

Hill: The only time I've seen it used is in very acrimonious situations and it's used as a hammer. I don't think it's a great tool, quite frankly.

At the onset of a deal, you're going into it saying that you'll exit the business together. Then, when five years is up and management doesn't think it's time to sell, you end up trying to force a process for a company with a management team that is very angry about the whole thing. You can imagine how well received that is by potential buyers.

Perhaps if they miss an Ebitda covenant or set another trigger you can flip the board, but at the end of the day, you have to work with the management team. Mark made a good point earlier, particularly regarding smaller businesses, that you may not see eye to eye with a CEO but in a lot of cases it's their relationships that carry a business, so you have to maneuver over the course of time and not do anything too drastic. Otherwise, you'll just harm your investment.

I can point to a deal from last year. The sponsors invested behind a consolidation strategy, and management ended up backing off of a couple of deals because the due diligence didn't check out. That forced them to miss their projected revenue numbers, which created a lot of tension. It was a pretty tough negotiation. The investors could have flipped the board and removed management, but at the end of the day, what would they have left? When you create so many metrics as a minority investor it can create its own set of problems.

Sinnenberg: I'd note that one of the ways we sell ourselves to potential partners is to provide a list, with contacts, of all of our prior portfolio companies. Because of this, it's in our best interest as a fund to make sure the deal is prosperous for everyone involved. But we're not going to go into a deal without a plan.

We try hard to not exercise the 'put,' but if you're not prepared to do it, I think you'll end up losing more money as a fund than you would care to lose.

Sullivan: I agree with that.

Sinnenberg: I would argue that 99% of the time the 'put' will never get exercised, but it always helps to focus the mind, so we do want that instrument in place.

Hill: I'm sure you remember when the VCs started to get rid of 'put' rights in their deals. They collectively said, 'We never exercise them anyway, so we don't want management to feel this undue pressure.' That lasted about three years, because management needed reminders that their investors had an established time frame.

We just spent an entire day with a client just hashing out the 'put' option. How would the investors be paid; how would the corporation be paid; what metrics would be used for the valuation; what specific triggers are in place to flip the board, et cetera?

Quite frankly, we probably spent more time than we needed to on it. I think the primary value is that it serves as a reminder that the investor needs to get liquid because they have their own limiteds to answer to.

Blair: If you're going to be a minority shareholder, by definition you're never going to be in control. This just allows us to get our money back.

Sullivan: Right. For us, it depends on how much we own. If we're going to own 35% or more, we wouldn't use a 'put;' we'd negotiate the option to drag them along and sell the business. It's a full-liquidity right. But if you're below 35%, that's not going to happen.

Mergers & Acquisitions: *What do these things tend to cost in terms of valuation? To go back to the right of first refusal, everyone agreed that this tends to impact the sale on the back end. You've also got all of these covenants that can either be very strict or relatively loose. Is it fair to say that all of this is reflected in the valuation?*

Isherwood: You can't just think of all of these covenants or approval rights in a vacuum. It's part of a package. I started out negotiating high yield debt covenants, and you can't just focus on one, figure that out, and move to the next one, because the whole thing is a give and take. Generally, you'll see the 'put' rights in there in some form or fashion, and there'll be approval rights, but it's highly negotiated and part of a bigger package.

Frankel: I actually think there's a subjective piece to it, in which a lot depends on what the parties believe is considered 'market' when it comes to the terms. Market terms are going to be free. Anything above that will cost you a lot of money.

Hill: I think that's very well stated. There's also an art to introducing and discussing your term sheet.

Blair: That's true. I find that we'll generally put in a very sensitive term sheet. We realize some of our competitors might only put in a two-page term sheet, while ours might be eight or nine pages. It helps avoid the situation in which you get to the table, your lawyer sends along the rest of the documents, and management is surprised by all of the terms. If you lead with that information, you put it all down without that initial interruption, then it's almost defined as your market right off the bat.

Hill: There are always two mindsets, and I agree with your point, David. If I'm on the receiving end, the more detail allows me to understand how you see the relationship working, no question about it. On the other hand, we may get a two-page term sheet that offers a seven percent premium on price, but we have no idea what they're going to put in their documents so we can't compare them -- it's apples and oranges.

Sinnenberg: That also is a function of how sophisticated the advisors are. We have the same philosophy as David, and we put through fairly expansive term sheets. But depending on the advisor, it could work against you. A lot of times you'll put through a detailed term sheet, the clients will sign on, and when it comes time for the discussions, they'll say, 'Oh, we didn't read that part,' or they'll try to negotiate those terms away.

Frankel: As a general rule, I tend to think there's too much faith in these mechanisms to solve problems. If you have to depend on a legal device to solve your conflict, you're probably already screwed.

Mergers & Acquisitions: *As a final question, I'd be curious to get a read on what the next 12 months will bring for the non-control market. Are we at that point where the traditional shops dipping into the market flee now that control deals are back? Or, alternatively, does the dislocation and the remaining pressure to put money to work mean that more and more shops will be targeting the non-control transaction?*

Sinnenberg: From my perspective, I can see two groups active in this market. There are those traditional PE groups, who aren't used to conceding that control, and then there are the people like those of us taking part in this roundtable, who come at it with a non-control mentality. I think it's a lot easier for those of us who are used to that mindset.

The thing I absolutely love about this business, which attracted me from the outset is that one of the least efficient segments of the US private equity market is captured in the difference you'll see between Libor plus three and the 17% for that next dollar that the senior lenders won't commit.

You don't find that difference when you go from mezz to a controlled entity. What's attractive about this space is that when you go from senior debt to mezz, the incremental return for the incremental risk is really attractive.

Frankel: One thought I have is that outside of the tech world, where minority investments are just part of the culture, I would love to see sponsors become more active as minority investors. There are so many things financial investors bring to these lower mid-market companies that -- from my perspective as a corporate buyer -- improve these companies as acquisition candidates.

Isherwood: I think minority-stake deals are going to continue to grow over time. They've historically been somewhat cyclical, and I think most owner/operators tend to go to the bank first when they want to build their companies. But as the population of funds with these capabilities grows, you'll see these types of deals more often. And despite the perception that bankers are motivated solely by fees, we're typically pretty agnostic in terms of how we set up our engagements. In fact, the thing that is most near and dear to our hearts is actually closing the transaction.

If a minority investment is the right way to go for a client, and there is a greater likelihood that there will be a transaction, that's what we will advise. M&A