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COVER STORY

Creative juices flow at private equity funds

Juliane Backmann / Special to the Daily Journal

Brett J. Rodda, a partner at Munger, Tolles & Olson LLP, said private equity investors have been using new methods to invest capital, including debt and minority-stake investing.

By Dominic Fracassa / Daily Journal Staff Writer

Facing persistently constrained and competitive outlets for the kinds of mega-deals that have defined them in the past, private equity and leveraged buyout funds have been getting creative when it comes to finding new ways to put their money to work. Tactics that these firms began to experiment with during the tumult of the nation's most recent financial crisis are increasingly finding their way into the pages of the private equity playbook.

While many corporate attorneys and financial analysts agree that macroeconomic conditions have been steadily, if slowly, improving year over year, the pace hasn't been fast enough for private equity investors eagerly waiting to deploy as much as $1 trillion in "dry powder," according to a report released earlier this month by Bain & Co.

"The environment for M&A buyouts is still not anywhere near what it was, so people are looking for places to put their money," said Munger, Tolles & Olson LLP partner Brett J. Rodda.

Rodda and other attorneys point to two new tactics in particular: debt lending, where a private equity fund takes on the role of a loan financier, and minority-stake investing, an approach private equity firms have not typically utilized in the past.

By most estimates, private equity funds began to dabble in debt financing between 2008 and 2010 — when credit markets were at their tightest.

"Traditional lenders just weren't there," Kirkland & Ellis LLP partner Jeremy M. Veit said. "Private equity funds found entry into the market and had real expertise that they could bring to bear. There's now more comfort for private equity funds investing across a capital structure, where historically they were experts in traditional [leveraged buyouts]."

San Francisco-based private equity firm Golden Gate Capital reaped the benefits of just such an arrangement in recent weeks.

In 2010, with revenues floundering, jewelry retailer Zale Corp. turned to Golden Gate for a $150 million loan. But a return based solely on the interest from the loan itself isn't what typically placates private equity investors, who aggressively seek out bigger returns in exchange for taking on more risk. Therefore, funds will also look to ensure that they'll be able to transform the debt they hold into equity if that company increases in value down the line.

"They want … the ability to have upside if there is an event that makes this company worth more than it is today," Rodda said.

In most cases, that means building convertible debt or warrants into deals — financial instruments that allow a private equity fund the option to take a stake in a company if equity proves to be more valuable than the debt itself, which it does in many instances.

Accordingly, Golden Gate retained just over 11 million warrants — a 25 percent stake in the company — which the fund could convert to shares at a discount if the company's bottom line began to buoy, which it did in earnest starting in 2013.

Last month, Zale announced it would sell to rival Signet Jewelers Ltd. for $690 million in cash. Golden Gate didn't disclose precisely how much it would make off of the deal, but with Signet's offer of $21 per share, Golden Gate's return is estimated at about $211 million.

Golden Gate, along with other California-based private equity firms including Altamont Capital, Hellman & Friedman and Silver Lake Partners all declined interview requests.

Minority-stake investing has also become a fashionable strategy among private equity funds, a notable departure from their reputation as financers interested only in buyouts and control.

In some ways, the approach is similar to that of venture or growth capital funds. But where venture capital usually looks to make a number of small investments across a range of companies in the hope that a handful survive to see a lucrative exit, Weil, Gotshal & Manges LLP partner Kyle C. Krpata said private equity funds tend to strategize a bit differently.

"On the whole, private equity funds tend to put more dollars to work on a single investment," he said.

Additionally, Krpata said, private equity investments tend to be in more stable, established companies with many of the same business fundamentals they would have sought out when looking to for a leveraged buyout opportunity, such as steady cash flow and an experienced management team.

Few private equity firms are willing to shed light on the kinds of minority investments they're making — particularly in privately held companies — but a handful of examples have made recent headlines.

Last month, San Francisco-based private equity firm TSG Consumer Partners LLC announced a $50 million investment in Revolveclothing.com, an online clothing retailer.

And in October, The Carlyle Group LP acquired a minority stake in Santa Monica-based consumer electronics company Beats Electronics LLC for $500 million. Munger Tolles advised Beats in that deal.

Adopting these new tactics, attorneys say, has been a relatively straightforward transition from a purely legal perspective. But in many instances, veering away from the traditional leveraged buyout model has meant taking on a set of concerns that private equity hasn't had to deal with in the past.

"A lender needs to worry about covenants, consent rights and its place in company's capital structure, and those are very different things to someone who's used to saying, 'I own this company,'" Rodda said. "Investing in a company rather than owning all of it entails many of the same concerns."

But conversely, Winston & Strawn LLP partner Eva Davis said that because the tactics themselves are fairly new, attorneys also have the ability to be creative in the ways they help their private equity clients structure deals.

"There's not a wealth of aggregated market information on minority investment deal terms for private equity," she said. "It gives you great flexibility to be creative when you're negotiating deal terms because you don't feel constrained by market norms."

And as markets have continued to improve, attorneys are also pleased by the broader impact of private equity's willingness to explore new financial tactics.

In addition to the infusion of new capital for companies, Dentons partner S. Elizabeth Foster said as funds continue to look beyond leveraged buyouts, the tension bred from competition between a small pool of funds for the same deals will be a boon as well.

"It's good for everyone in the market," Foster said.

"The companies that want to sell will see money starting to move, and because private equity investors have become more flexible, maybe they're willing now to consider alternative structures and alternative deals that they wouldn't have looked at in the boom times."