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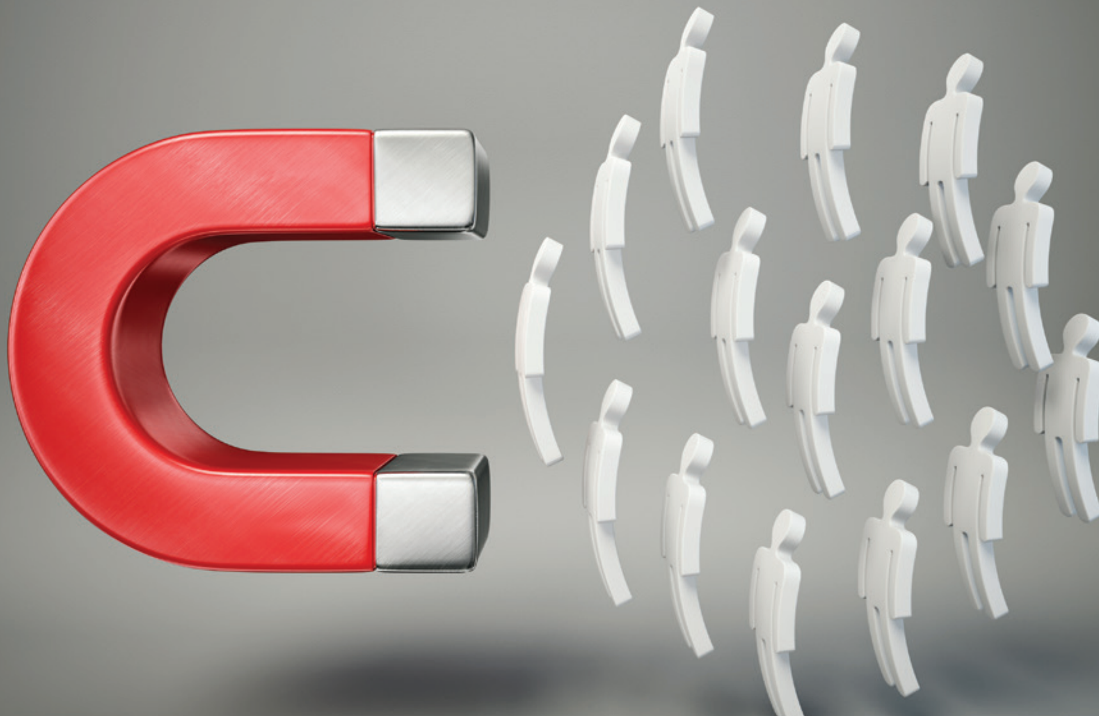
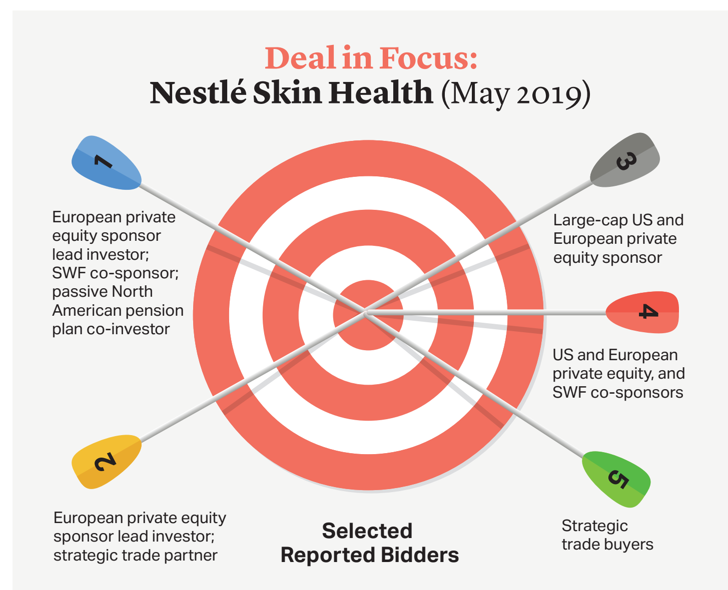


Key Pros and Cons of Consortium Deals for Investors

Consortium deals are firmly back in fashion as deal size and multiples in European private equity transactions continue to increase. Last year, multiples passed the 11.6x (EV to EBITDA multiple) high water mark of 2007 and equity cheques rose to a 5.7x high according to figures from PitchBook, providing an impetus for private equity buyers and other principal investors to pool financial resources and spread risk in order to bid for larger targets.

Two of the highest profile deals in Europe in the first half of 2019 involved consortium bids, with the auction process for Nestlé Skin Health seeing various consortiums enter the fray before a CHF 10.2 billion deal was announced in May with a consortium led by EQT and a Middle Eastern Sovereign Wealth Fund, along with PSP Investments and other large institutional investors.

Similarly, the UK satellite operator Inmarsat's £2.6 billion take-private attracted attention from a number of suitors before being acquired by a consortium made up of Apax, Warburg Pincus and two Canadian pension funds, the Canada Pension Plan Investment Board and the Ontario Teachers' Pension Plan Board.



Benefits of partnerships

Private equity sponsors are increasingly partnering with other financial sponsors and principal investors to execute transactions that they may not be willing or able to achieve alone. Aside from diversification and risk spreading considerations, partnership arrangements allow financial sponsors to pool sector or geographic expertise and jointly leverage financing relationships to obtain more attractive terms.

Linking up with strategic acquirers can also provide a sponsor group with a unique angle and a competitive edge over other bidders. Industrial buyers or experienced operating partners can give a financial sponsor credibility with the target and unlock synergies not otherwise achievable, as well as providing significant commercial and operational expertise.

The variety and combinations of parties coming together in consortiums is no longer limited to traditional club deals, strategic joint ventures or passive co-investment paradigms. Financial investors have become increasingly willing to assume a variety of roles, ranging from lead investor through to co-sponsor, underwriter or passive co-investor, depending on the nature of the transaction, their own resources and expertise and the alignment of interests with other members of the group. The recently agreed £4.8 billion take-private of Merlin Entertainment saw Kirkbi, a strategic family investment office, team up as equal partners with Blackstone and the Canada Pension Plan Investment Board.

Despite the obvious advantages of partnering with others, private equity sponsors should be mindful of the potential pitfalls associated with consortium deals; they can add significant complexity to a buy-side M&A process, burden all consortium members with regulatory impediments faced by individual members and, if not managed properly, have the potential to throw up complex legal and commercial issues that can ultimately prejudice the attractiveness of a buy-side proposal and create significant execution risk.

Set out with a clear operating framework

One critical element of a successful consortium deal is setting out a clear operating framework early. A preliminary agreement, referred to as a bid conduct agreement or a joint bid agreement, should be entered into to cover the period leading up to the execution of transaction documents. This will address issues such as bid negotiation, governance or control, appointment of advisors, equity commitment principles, syndication rights, approach to antitrust and regulatory filings, consortium admission and withdrawal rights and the allocation of fees and expenses, including those already incurred by the lead investors.

Bid conduct agreements should be considered as early as possible in the process, because while certain aspects of the bid and the consortium's relationship will develop over the course of the transaction, it is important to have a binding framework agreement in place to ensure alignment, and a back-stop in the event that the transaction is abandoned at an early stage. Critical provisions may also be included in back-to-back NDAs entered into by consortium members with lead sponsors.

Depending on the timing of the transaction, including both the anticipated pre-closing period and time available for negotiation pre-signing, more detailed terms regarding the consortium's relationship may be set out in an interim investors' agreement entered into at the signing of the transaction. Otherwise, these will be included in a long-form consortium governance agreement entered into at closing.

Consortium Types

1. **Traditional Private Equity Syndicate (or "Co-sponsor" or "Club Deal")**: Two or more private equity sponsors or, increasingly SWFs or pension funds, work together as partners to effect a transaction. Co-sponsors typically work actively as equal partners to design, diligence and execute the transaction and manage the investment, but the group may include one or more "lead sponsors".
2. **Co-investment (or "Passive" co-investment)**: Typically offered by private equity sponsors to existing or prospective investors. Co-investors remain passive, economic participants and typically invest through a sponsor-managed entity.
3. **Strategic Partnerships**: The group is typically led by one or more private equity sponsors with support from a strategic investor or other industry partner providing specific expertise or resources. Strategic investors may have particular focus on a portion of the target business or certain assets, which may be subject to an on-sale agreement to the strategic investor or separate governance or operational arrangements.
4. **"Allsorts" Consortium**: May comprise private equity, strategic or other principal investors in any combination and include sub-groups or strata within the consortium (e.g., co-lead sponsors, co-sponsors, strategic investors and passive co-investors).
5. **Joint ventures**: Consortiums may exhibit characteristics more usually associated with joint ventures, including where the lead investors contribute their specific expertise or resources to different aspects of the transaction, or intend to use the investment as a basis for a platform or other long term investment in which they may make add-on investments.

Key areas to consider

CONSORTIUM GOVERNANCE

Bidders in a competitive auction process need to be able to move quickly and decisively, and so cumbersome decision-making processes need to be avoided in favour of facilitating a coherent and agile approach toward the seller. In private equity-led consortiums, often one or two lead sponsors will be given authority to make almost all decisions on behalf of the consortium and provide a single point of focus for legal and commercial diligence. Without a lead, investors can run the risk of negotiating themselves to a deadlock or overwhelming sellers with a crowded negotiating table and overlapping diligence processes.

Once the deal is agreed, governance is typically allocated proportionately to each consortium member's financial commitment, both in relation to the exercise of rights under the acquisition documents and management of the investment generally. Some strategic or operating partners may be allocated outsized rights in recognition of their valuable non-financial contribution to the consortium. With smaller consortiums of two or three parties, it is common for a significant number of matters to require unanimity among the members.

Multi-party consortiums that do not have a single lead sponsor often find control more fluid under a so-called shifting alliance structure. This results in no one party having the ability to direct or veto any specific matter, with only a very small number of critical matters – such as price – being subject to supermajority or unanimous approval.

FEES AND EXPENSES

The exposure of each member of the consortium to transaction costs and expenses should be established quickly. In the event of a successful transaction, all costs should be borne by the new consortium vehicle, but if not – and if an abort or break fee is not payable by the seller – then costs will need to be allocated among the consortium. This is usually done pro rata according to preliminary equity commitments, with any investors that have withdrawn required to pay fees and expenses incurred up to the point of withdrawal in the event of an unsuccessful deal.

Consortium members may be charged transaction fees by the lead sponsors. Transaction fees can come in various guises and include deal sourcing fees (typically 1-2% of enterprise value), underwriting fees and regular asset monitoring fees. The nature and quantum of any fees depends to a large degree on the identity and commercial relationship of the consortium members and on the nature of the asset, which may or may not require additional technical skills to transition, manage and monitor. The characterisation and structure of fees payable needs careful consideration, particularly if the services are provided in the UK and may be regulated.

STRUCTURING

Aside from obvious tax structuring considerations which may be particularly difficult to align in a consortium with a mix of private equity, strategic, US-based and non-US based members, if there is any EEA nexus to the consortium, careful thought should be given at an early stage to whether or not the consortium vehicle will be an Alternative Investment Fund for the purposes of AIFMD, and therefore require approval and ongoing authorisation.

The analysis of any structure is highly fact specific and generally turns on whether there is a collective investment undertaking (or whether consortium members have day-to-day control over operational matters) that has raised capital (rather than consortium members coming together on their own initiative to form the consortium to deploy capital). The approach of regulators across the EEA can vary; while the FCA has provided helpful indicative guidance on joint ventures, particular care should be taken by consortiums involving members or co-investments from the Netherlands, Ireland, France, Germany and Denmark.

TRANSFERS AND EXITS

One of the trickiest areas for negotiation in consortium deals is transfer restrictions and how governance rights will be affected by future sell-downs or dilution, particularly where consortium members have different views on the optimal exit timing and structure.

Interests in the consortium are commonly subject to a lock-up of at least several years post-closing, with the exception that lead sponsors will typically have the right to syndicate a significant portion of their interest within a defined period of six months to a year. Transfers to affiliates will usually be permitted, and early exits may also be permitted where a minimum return threshold is reached or if investors have clear and unavoidable timing requirements at the outset, such as fund terms.

All consortium members should take care to understand the structure of their counterparties to ensure that exits cannot be achieved through the back door. English law in particular has raised significant doubts as to whether generically drafted prohibitions on indirect transfers or transfers of any interest in shares will provide sufficient protection.

There is no one-size fits all approach to the impact of shifting interests on consortium governance. Matters that should be considered include whether the right to appoint directors should be tied to a minimum shareholding or the right to appoint multiple directors should be scaled down proportionately, and whether minorities can aggregate their holdings to appoint board representatives or veto material consortium decisions.

A View From The Sell Side

1. **Competition**: Permitting consortiums in sale processes may bring larger assets in to play for a greater pool of potential buyers but sell-side advisors will be concerned about price collusion or the lessening of competition from independent bidders, particularly given the typical "exclusivity" undertakings in bid conduct agreements or consortium NDAs which will lock-in potential buyers to a particular consortium at an early stage. Sellers will seek to put strict controls and elicit transparency on consortium activity through their own NDAs.
2. **Process and Negotiation**: Sellers will seek to focus negotiations with the smallest possible group and avoid any delays, confusion or mixed messages which could result from open negotiations with all consortium members looking to drive terms. Consortium members commonly bridge these concerns by dividing primary responsibility for negotiation between different aspects of the deal (e.g., acquisition, financing, management arrangements, further syndication).
3. **Anti-trust**: "Joint control" by consortium members may trigger anti-trust notifications where turnover or other thresholds would not otherwise be met, and sellers will typically be very interested in understanding consortium arrangements to enable them to weigh up any substantive issues which may arise or be exacerbated as a result of the consortium members' interests and which could impact deal execution.
4. **Execution Risk**: Consortium dynamics can complicate approval processes in regulated industries, in which individual approval thresholds may be required as low as to 10% economic interests (and see above regarding "anti-trust" considerations) and sellers will be keen to limit the involvement of consortium members who may bring additional regulatory risk. Sellers will also expect the lead consortium members to stand behind equity commitments and deal with back-to-back arrangements with other consortium members "behind the scenes" to provide additional execution certainty.

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