

# Private Equity exits

## Introduction

A feature of acquisitions by private equity (PE) investors is the focus the PE investor has from the outset on how it will exit from its investment.

That focus is generally driven by two key factors:

- the illiquid nature of an investment in PE, as opposed to publicly listed equity, which means there is no readily available way to realise capital gains on the investment, and
- the limited life-time of the underlying fund that has provided the equity for the investment, which means that before the end of the fund's life the investment must be realised even if the potential exists for further growth in the value of the investment.

Recent data indicates that a PE investor in the New Zealand market will typically look to exit within about three years after its initial investment<sup>1</sup>.

If a PE investment has been unsuccessful, the PE investor's exit is likely to be by way of:

- a voluntary liquidation of the investee company
- a sale of the PE investor's shareholding to another shareholder (often the management team) pursuant to a put option or a redemption by the investee company of preference shares held by the investor (in each case often for a low price), or

- a transfer of the PE investor's shareholding to the bank that provided the debt finance for the original investment (which will then try to sell the unsuccessful business).

This newsletter briefly considers, from the perspective of the PE investor, some key legal aspects of the main exit routes we expect to see taken by PE investors over the next few years in the New Zealand market where the PE investment has been successful. These are:

- an IPO of the investee company (or its new holding company)
- a sale of the investee company to a trade purchaser, and
- a secondary buyout, in which the investee company is acquired by a new PE investor together with the existing management team<sup>2</sup>.

## Exit aspects of the initial investment documentation

As a successful exit requires the support and involvement of the management team, and to limit the potential for future disagreement between the PE investor and the management team, the original investment documentation agreed by the PE investor and the management team will typically contain a number of provisions that are designed to protect the PE investor's position with an exit in mind. Such provisions include:

- a general provision stating that the investor and management will work together to achieve an exit as soon as reasonably practicable (sometimes the provision will more specifically say that the investor and management will use reasonable endeavours to achieve an IPO by a specified date)
- a provision stating that the investor will not be required to give any warranties or representations on a trade sale of the investee company (other than as to ownership of any shares to be sold by the investor at that time)
- pre-emptive and other provisions restricting almost all share transfers by the management team without the investor's consent, to avoid partial sales during the term of investment that alter the exit focused shareholding structure established at the outset
- liquidation and sale preference provisions under which the investor is entitled to a priority return from the proceeds of the liquidation or sale of the investee company, to ensure that the investor receives a level of return (sometimes just its initial investment) back before any proceeds from the transaction are distributed to the other shareholders
- IPO preference provisions under which the investor is entitled to a preferred return

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<sup>1</sup> See p11 of "The New Zealand Venture Capital & Private Equity Monitor 2006" produced by Ernst & Young in association with the New Zealand Private Equity & Venture Capital Association.

<sup>2</sup> Recent secondary buyouts include Next Capital's acquisition of a stake in Hirepool from Goldman Sachs JB Were NZ and Catalyst's acquisition of a stake in EziBuy from Direct Capital.

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on a flotation, usually by way of the investee company's share capital being reallocated through the use of dilutive conversion rights or a bonus share issue, the purpose of which is to ensure that at the time of flotation the investor has an increased share of the investee company's capital (and therefore a greater share of the total value of the flotation)

- “drag along” provisions that allow the investor to require the sale by the other shareholders of all of their shares of the investee company (so that 100% of the company can be offered to a prospective purchaser and the value of the investment is maximised).

### **IPO exits**

Key issues for PE investors considering an exit by way of an IPO include:

- an IPO is not an exit in itself - the investor will only exit when it sells its shares in the listed company. That will generally only happen some time after the flotation because any investment bank underwriting the flotation will typically require the investor to enter into a lock-up agreement that broadly restricts the investor from dealing with its shares in the listed company for a specified period of time after flotation (because of the adverse effect a quick sale after flotation would be likely to have on the market value of the listed company). The various carve-outs from the lock-up restrictions are likely to be a key negotiation issue between the investor and any underwriter
- the impact of any pre-IPO reorganisation of the investee company's capital structure on the investor's legal position in relation to the company and its other shareholders. In particular, the rights, protections and controls that investors seek to have included in the investment documentation are incompatible with listed company status and will be removed as part of the reorganisation. The continuing exposure to market risk for a period of time after a flotation, during which period the investor will no longer hold the rights and protections previously held by it under the investment documentation, is a key disadvantage of an IPO exit for a investor and it is critical from the investor's perspective that any such reorganisation is conditional upon the flotation taking effect
- the extent to which the investor is required to give warranties and indemnities to any underwriter of the flotation. It is generally accepted that, given its position as an external financier and the fact it is not responsible for managing the investee company's business, the warranties the investor is required to provide will be limited to information about itself.

### **Trade sale exits**

For PE investors, the most significant benefit of an exit by trade sale rather than an IPO is that a trade sale usually enables an immediate and complete exit. PE investors also often prefer an exit by trade sale because of the relatively simple and quick process of, and the significant control that can be exerted through, negotiating with a single trade buyer.

Key issues for PE investors considering an exit by way of a trade sale include:

- possible resistance to a trade sale from the management team, which might be concerned about how a change in ownership will affect their positions

- ensuring a “clean exit” without ongoing obligations under the share sale agreement. Historically, investors exiting through a trade sale have refused to provide any indemnities (including tax) and warranties to the purchaser (other than as to ownership of the shares and valid execution of transaction documents). The main arguments made by PE investors in support of this position, and these have become generally accepted within the New Zealand PE market, are that:
  - because they have not been closely involved in the day to day management of the business, they have no way of assessing the level of risk associated with giving business related warranties and indemnities, and
  - the structures of their underlying funds, in particular the requirement to return funds to the fund participants, restrict the investors from retaining contingent warranty / indemnity liabilities post-sale
- avoiding, to the extent negotiable with the purchaser, deferred consideration mechanisms such as earn-outs. PE investors acting as vendors on a trade sale will generally seek to avoid such mechanisms because their key objective is to achieve a quick distribution of proceeds to the investors in the underlying investment fund
- avoiding, to the extent negotiable with the purchaser, restrictive covenants that might restrict the investor from making future investments in the industry concerned.

### Secondary buyouts

If the New Zealand market follows a similar path to the Australian and UK markets then secondary buyouts in New Zealand are likely to increase significantly over the next few years.

In many ways secondary buyouts are structured in the same way as conventional management buyouts, but there are some key differences for exiting PE investors. In particular, on a secondary buyout there is a conflict between the selling PE investor’s wish for a “clean exit” (as discussed above) and the purchasing PE investor’s wish for strong warranties and indemnities to protect its investment.

Possible solutions to this apparent conflict include:

- the purchaser relying on warranties solely from the management team. In this case the purpose of the warranties becomes more to trigger disclosures than to provide a means of recourse (apart from the financial limitations of management backed warranties, which will generally be capped at the level of the price received for sale of their shares in the target, the purchasing PE investor will of course want to avoid litigation against what will have just become its own management team)
- the management team warranties being capped in excess of their share sale proceeds, with the selling PE investor agreeing with the management team that it will contribute proportionately to any warranty claims by the purchasing PE investor
- the management team warranties being capped in excess of their share sale proceeds with the excess being backed by insurance with a warranty and indemnity insurance provider.

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# Further information

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The PE purchaser on a secondary buyout should also be able to derive some comfort from the fact that the target business will already (probably in the previous few years) have been through a due diligence process conducted by the PE vendor which should have flushed out any material issues with the target business existing at the time of the original buyout.

## How we can help you

If you would like to speak to us with respect to any of the issues noted in this newsletter, please contact any of the people listed in the margins of this newsletter.

Our PE team has extensive experience advising PE investors, management, debt providers and other parties on all aspects of PE transactions across New Zealand and Australia, including:

- leveraged and management buyouts
- management incentive structures
- investor exits, including IPOs and trade sales
- the structuring, launch and management of PE funds and other investment vehicles.

We offer a seamless service with our colleagues at Minter Ellison in Australia on trans-Tasman deals. Our team includes M&A, financing, tax and funds experts and offers a comprehensive service.

Our team works closely with the New Zealand Private Equity & Venture Capital Association (NZVCA) and the Australian Private Equity & Venture Capital Association Limited (AVCAL) to grow and develop the sector in New Zealand and Australia.

For further information, a PE team contact card and brochure with examples of recent PE deals and start-ups we have worked on, are available at [www.minterellison.co.nz](http://www.minterellison.co.nz).

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