Bespoke Portfolios

In 10 Clicks, 10 Minutes, 1/10th Cost

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Acquisition of a Minority Interest from Financial Sponsor

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Acquire a Minority Interest

Rationale

Acquiror	Financial Sponsor
▪ Potentially pre-empts sale to, or partnership with competitor ▪ Minimizes financing requirements for entire asset purchase ▪ Learning ▪ Path to ultimately gaining control ▪ Less risk if acquired asset doesn't perform	▪ Partnership with another industry participant ▪ Cash infusion enables avoiding decision of whether to invest additional funds in near term ▪ Retain upside in residual majority investment ▪ May receive a higher value for initial purchase

Issues

- Valuation will be dependent on percentage acquired and key terms including governance, liquidity, business agreements
- Acquiror's ability to 'fully commit' to arrangement is highly dependent on certainty of its path to control
- May achieve fewer combination benefits than envisaged, given relatively small ownership interest

Structuring Considerations

Minority Interest: Path-to-Control – Potential Options

Mechanism	Advantages	Disadvantages
Put / call provisions or agreement to purchase at later date	▲ Locks in ultimate control of asset ▲ Control of price, or pricing mechanism ▲ Could insure against paying for value created or enabled by minority investor ▲ Control of timing of ultimate purchase	▼ Price of initial investment may be higher than options described ▼ May have to guarantee price, even if operations do not support valuation ▼ Valuation mechanisms usually create disputes and draw out processes ▼ Negotiation of mechanism can be highly contentious/time consuming
Right of First Refusal	▲ Locks in ultimate control of asset ▲ May discourage other potential suitors in future	▼ Does not control transaction timing ▼ Subject to valuation risk ▼ May be forced to overpay to protect a strategic asset ▼ May pay for value created, or enabled, by minority investor
Negative Control / Veto Rights	▲ Locks in ultimate control of asset ▲ May not have to pay for full control premium ▲ May discourage other potential suitors	▼ Does not fully lock in control ▼ Not as clear of a message to the investment community ▼ May pay for value created or enabled by minority investor

Structuring Considerations

Structuring Considerations

In scenario where Acquiror acquires small stake in Portfolio Company from Financial Sponsor, shareholder agreement becomes very important

Governance	Exit and Liquidity
▪ Board representation	▪ Dispute resolution mechanism
▪ Veto rights (over mergers and acquisitions, asset dispositions, issuance of new equity)	▪ Sale of interest
▪ Right to appoint officers	▪ Put/call on investment
▪ Ability to approve business plan	▪ Anti-dilution
▪ Related party transaction approvals	▪ Drag-along rights
▪ Limits on debt levels	▪ Tag-along rights
▪ Profit distribution provisions	▪ Rights of first refusal/offer
▪ Information and inspection rights	▪ Post-IPO standstill
	▪ Registration rights
	▪ Demand and/or piggyback
	▪ Order of preference

Structuring Considerations (Cont.)

Type of securities issued will have impact on ownership, governance and pricing

Common Stock

- ▲ Simple structure
- ▲ Significant cash inflow with low current yield
- ▲ Lowest cost involved to issue
- ▲ Allows strategic alliance to develop over time
- ▲ Can feature attached warrants or detachable rights

- ▼ Immediate voting rights
- ▼ Holder is generally given board representation in approximate proportion to ownership interest
- ▼ Difficulty in structuring additional features
- ▼ Premium may be lowest
- ▼ Primary shares immediately dilutive to common shareholders

Convertible Preferred

- ▲ Ease of structuring features (more issuer protection — call premiums, transfer of ownership, exercise and registration rights, etc.)
- ▲ Not immediately dilutive to common shareholders
- ▲ In return for current yield and other enhanced provisions, conversion price for underlying common stock may be lower

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- ▼ Complex structure
- ▼ Offers holder, in some cases, special voting rights as a separate class, or upon conversion, voting rights equal to those of underlying common stock
- ▼ Current yield (dividends)
- ▼ Holder is generally given board representation in approximate proportion to ownership interest

Convertible Debt

- ▲ Ease of structuring features (more issuer protection — call premiums, transfer of ownership, exercise and registration rights, etc.)
- ▲ Voting rights only after conversion
- ▲ Board representation only after conversion
- ▲ Issuer receives interest expense deduction
- ▲ Not immediately dilutive to common shareholders
- ▲ Conversion price for underlying common stock may be lower

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- ▼ Complex structure
- ▼ Current yield (interest)
- ▼ Convertible debt has more senior position than equity or preferred, upon liquidation

Structuring Considerations (Cont.)

Alternative	Attractiveness to: PE / Hedge F.	Strategic	Investor (A)	Investor (B)	Considerations
Total Equity Stake Sold					
Typically Up to ~30%	✓✓	✓	✓✓	NA	▲ Limited governance provisions required by investors ▲ Increases likelihood of dealing with a single buyer ▲ Smaller stake expands universe of potential participants able to purchase substantial portion of equity offered, thereby likely enhancing value extraction ▼ Limits overall monetization ▼ If stake sold is below approximately 15%, likely not as attractive to rating agencies as larger monetization ▼ Not taking full advantage of buyer demand?
Typically Up to 50%	✓	✓✓	✓	NA	▲ May enhance rating agencies' view on debt being non-recourse to Seller ▲ Maximizes proceeds ▼ More challenging to retain full control – give up negative control ▼ Negotiating with multiple parties more likely ▼ Exit strategy for financial investors may be more difficult

Structuring Considerations (Cont.)

Alternative	Attractiveness to: PE / Hedge F.	Strategic	Investor (A)	Investor (B)	Considerations
Number of Investor(s)					
One	✓✓	✓✓	✓	✗	▲ Least complicated sale process / negotiation ▲ Sale to "highest bidder" most likely ▲ Depending on identity of equity investor, may be most attractive to rating agencies ▲ "Marquee" partner provides further validation ▼ Depending on size of stake sold, may need to give partner certain governance and / or operational rights ▼ Limits number of potential buyers due to size of equity check required
2-4	✓✓	✗	✓✓	✗	▲ Expands pool of potential buyers ▲ No single partner likely to have any material role in governance or operations ▼ Sale process more complicated
5+	✓	✗	✓	✓	▲ Diversified ownership, with higher liquidity for equity partners ▼ Waning interest from many buyers as size of commitment decreases ▼ Subject to "lowest common denominator" dynamics ► Sale process structured largely like a private placement

Structuring Considerations (Cont.)

Alternative	Attractiveness to: PE / Hedge F.	Strategic	Investor (A)	Investor (B)	Considerations
Investment Structure					
Sale of Interest in Specific Assets	✗	✓	✗	✓✓	▲ Potential to achieve “above-market” value from certain buyers with interests in specific assets ▼ Unlikely to achieve significant proceeds ▼ Complicates sale process
Seller Sells Equity Interests in interim Special Purposes Vehicle (SPV)	✓✓	✓✓	✓✓	✗	▲ Validates investment thesis of plan ▲ Returns cash to Seller ▲ Straightforward process ▼ Does not reduce financing requirement (no additional equity seen by lenders)
Equity Issuance by SPV	✓✓	✓✓	✓✓	✗	▲ Validates investment thesis of plan ▲ Proceeds to SPV can be utilized for further growth ▼ No proceeds to Seller

Structuring Considerations (Cont.)

Alternative	Attractiveness to: PE / Hedge F.	Strategic	Investor (A)	Investor (B)	Considerations
Structure of Equity Interests					
Common Equity	✓✓	✓✓	✓✓	✗	▲ Maximizes validation of plan ▲ Highlights value of Seller stake ▲ Least complicated option ▲ Maximum equity credit for rating agency purposes ▼ Less flexibility to tailor security for specific investor(s) ▼ Governance / voting more directly linked to percentage ownership
Preferred Stock	✓✓	✓	✓✓	✗	▲ Potential to offer liquidity / enhanced flexibility via convertible option ▲ Generally lower cost than common equity ▼ High debt level limits ability to pay cash coupon ▼ PIK structure can significantly erode Seller's equity stake ▼ Complicates governance / structure ▼ Less equity credit for rating agency purposes; may adversely affect debt credit rating
Alternative Consideration					
Seller Stock (i.e., Split-off)	✗	✗	✗	✗	▲ Provides Seller shareholders ability to "focus" investment ▼ Requires public equity investors to swap into less liquid, private security ▼ Seller shareholder base unlikely to possess optimal combination of risk appetite / return expectation
Assets	✗	✓	✗	✓	▲ Expands and diversifies asset base, potentially into other attractive regions ▲ May have tax advantages to counterparty ▼ Limited number of potential counterparties ▼ Relative vs. absolute valuation more challenging ▼ More likely to require sharing certain operational responsibilities

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Structuring Considerations (Cont.)

Alternative	Attractiveness to: PE / Hedge F.	Strategic	Investor (A)	Investor (B)	Considerations
Timing of Equity Investment					
100% Upfront	✓	✓	✗/✓	✗	▲ Maximum validation of story ▲ Immediately diversifies Seller risk ▲ Maximizes positive impact with rating agencies ▼ Buyers will apply higher discount rate to pre-completion period ▼ Yield-focused buyers sensitive to lack of returns on invested capital in early years
Drawdown over Time	✓✓	✓✓	✓✓	✓✓	▲ Investor(s) likely to use lower discount rate to account for less uncertainty around completion ▼ Less upfront cash ▼ Less attractive from rating agencies' perspective; highly dependent on degree of conditionality of commitment
Sale Process					
Allow Pre-emptive Approach	✓✓	✓✓	✓	✗	▲ Ability to explore potential partnership with preferred partner ▲ Minimizes time and resource requirements of process ▲ Can be pursued without materially delaying or impeding a broader process ▼ Investor(s) will be unwilling to be a "stalking horse" without compensation ▼ Foregoes competitive dynamic to drive pricing ▼ Risk of insufficient information being available for firm bid prior to broader process

Governance Considerations

Seller will need to determine its willingness to accommodate minority investors' governance requests

Typical Provisions	Comment
Dividends / Distribution Policy	▶ Investor(s) will require clear parameters that dictate and govern timing and quantity of profit distribution
Veto Rights	▶ Investor(s)' request for veto rights highly dependent on size of investment and number of investors ▶ May govern mergers, acquisitions, ownership changes, asset transfers, issuance of new securities, changes to O&M and other "intercompany" agreements and changes to governance provisions
Ability to Approve Business Plan	▶ Investor(s) will seek to protect themselves against major changes in business
Board Representation	▶ Minority investors often request Board representation proportionate to ownership
Additional Equity Issuances	▶ All investors may require approval rights for additional equity issuances
O&M Responsibilities / Other Affiliate Contracts	▶ Minority investors will require clear guidelines regarding provision of services by Seller ▶ Investor(s) will likely require veto rights with regards to major changes to any "intercompany" agreements
Day-to-day Management	▶ Investor(s) may seek to influence day-to-day management either through board representation, management committee(s) or investor representation on management team
Dispute Resolution Process	▶ Fair and equitable dispute resolution process will be sought by minority investors
Limits on Debt Levels	▶ Equity investors likely to be particularly concerned about restricting leverage, given structure of debt financing
Other Legal Arrangements	▶ Equity investors may need to enter a non-compete agreement

Governance Considerations (Cont.)

Company will need to determine its willingness to accommodate minority investors' governance requests

Typical Provisions	Importance to: Sponsor	Importance to: Strategic	Comment
Board Representation	✓✓	✓✓	▶ Investor will request Board representation that is proportionate to ownership
Veto Rights	✓✓	✓✓	▶ Extensiveness of veto rights highly dependent on size of investment ▶ May govern mergers, acquisitions, ownership changes, asset transfers, issuance of new securities and changes to governance provisions
Day-to-day Management	✓	✓✓	▶ Investor(s) may seek to influence day-to-day management either through board representation, management committee(s) or investor representation on management team
Dispute Resolution Process	✓	✓	▶ Fair and equitable dispute resolution process will be sought by investor
Ability to Approve Business Plan	✓✓	✓✓	▶ Investor(s) will seek to protect itself against major changes in Company's operations
Additional Equity Issuances	✓✓	✓✓	▶ Investor(s) may require approval or pre-emptive rights for additional equity issuances in future
Dividend Policy	✓✓	✓✓	▶ Investor(s) will require clear parameters that dictate and govern timing and quantity of profit distribution
Limits on Debt Levels	✓	✓	▶ Strategic investor may want to limit leverage levels
Other Legal Arrangements	✓	✓✓	▶ Investor(s) may need to enter a non-compete and non-solicit agreements ▶ Strategic investor may require creation of cooperation agreements / preferred provider

Note: Number of check marks indicates level of importance.

Liquidity / Exit Considerations

Liquidity and exit opportunities particularly important to private equity investors sometimes, due to their typically shorter (5-7 year) holding periods

Typical Provisions	Comment
Risk Sharing Mechanisms	▶ Investor(s) may request protection against risks or other material changes to scope and size ▶ Protection mechanisms potentially requested may include put rights for all or parts of investment, or an adjustment in minority investor's ownership stake upon material changes
Anti-dilution	▶ Investor(s) are likely to require some form of protection against dilution of their stake, either through veto rights and / or ability to participate in any additional equity issuances etc.
Lock-up Period	▶ Lock-up provisions extending beyond operational date will have negative value impact ▶ Investor(s) will also likely require that lock-up can be waived under certain circumstances, like material changes to size or scope of business ▶ Lock-up will be important to rating agencies
Right to Approve New Owners	▶ Seller approval right over sale of investor stake will impact value
Tag-along / Drag-along Rights	▶ Potential investors strongly desire tag-along rights; drag-along rights requested by investors would likely not be acceptable to Seller
Right of First Refusal (ROFR) / Right of First Offer (ROFO)	▶ ROFRs / ROFOs are typical and would be an expected provision by most investors ▶ Value impact of ROFO largely dependent on specific structure of provision
Registration Rights	▶ Lack of near-term registration rights usually not expected to be a major detriment to value, given nature of potential investor universe; however, private equity investors attribute significant value to registration rights at a future date

Liquidity / Exit Considerations (Cont.)

Liquidity and exit opportunities critical to financial sponsors and strategic partners, who will seek to time market – whether public or private – and maximize their rate of return

Typical Provisions	Importance to: Sponsor	Importance to: Strategic	Comment
Forced IPO / Sale	✓✓	✓	▶ Investor is likely to want ability to force an IPO and / or sale at some time in future if a liquidity event has not otherwise occurred
Put / Call Options and Risk Sharing Mechanisms	✓✓	✓	▶ Investor may want a put option and Acquiror may want a call option in event either party wishes to sell its holdings in Company with Company's valuation determined by an appraisal process ▶ Protection mechanisms potentially requested may include put rights for all or parts of investment, or an adjustment in investor's ownership stake upon material changes to Company
Registration Rights	✓✓	✓	▶ Once public, investor may want registration rights that allow it to sell shares in a public offering ▶ Sponsors attribute significant value to registration rights at a future date
Anti-dilution	✓✓	✓✓	▶ investor is likely to require some form of protection against dilution of its stake, either through veto rights and / or ability to participate in any additional equity issuances etc.
Sale of Interest	✓✓	✓	▶ An approval right granted to Acquiror over any sale by investor its stake to third parties will impact value
Tag-along / Drag-along Rights	✓✓	✓	▶ Investor likely to want tag-along rights which allows it, should Acquiror sells its shares to third parties, to participate in such sale at same price and terms as Acquiror ▶ Acquiror may want drag-along rights which allows it, upon sale of Company shares to a third party, to force investor to sell its interests to such third party ▶ Potential investors typically strongly desire tag-along rights
Right of First Refusal (ROFR) / Right of First Offer (ROFO)	✓✓	✓✓	▶ ROFR grants other party the right to "first refuse" shares before selling party can sell its Company shares to third parties ▶ ROFO requires selling party, before selling shares to third parties, to first offer such shares to other party ▶ ROFRs / ROFOs are not unusual and can be reciprocal ▶ Value impact largely dependent on specific terms of provision, such as valuation mechanisms and threshold triggers
Post-IPO Standstill	✓	✓✓	▶ If Company goes public, a standstill provision restricts investor from increasing its ownership

Note: Number of check marks indicates level of importance.

Exit Pathways for Partners / Investor(s)

Any sale of equity must provide a true pathway to an exit in future for new investor.

Strategic Partner

- Strategic partners can be longer–term focused, but they too will have specific liquidity / monetization needs
- Will seek liquidity through several pathways (IPO / sale / put); may not need all, but will want some

Financial Sponsor

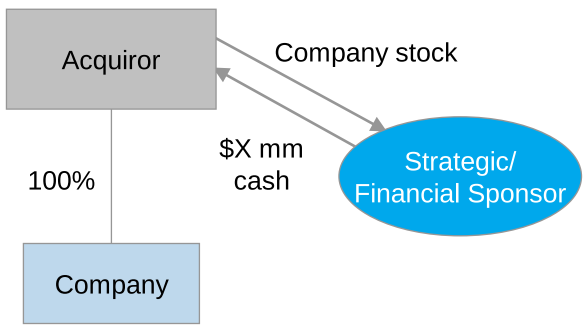
- Sponsor will require enough alternatives – IPO, sale, and/or puts – to ensure liquidity
- Will seek to control time frame available to exercise exit rights
- IPO and put will be particularly important if sponsor perceives today that a future exit based on a sale can only be achieved with another sponsor; sponsor–to–sponsor sale of a minority stake less likely in general

Illustrative Transaction Diagrams

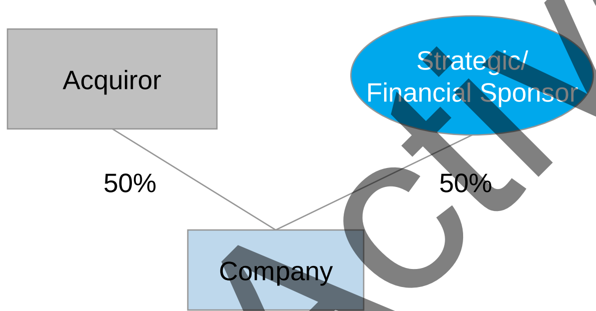
Illustrative Transaction Diagrams (Existing Leverage)

Sell Equity

Step 1: Equity Investment

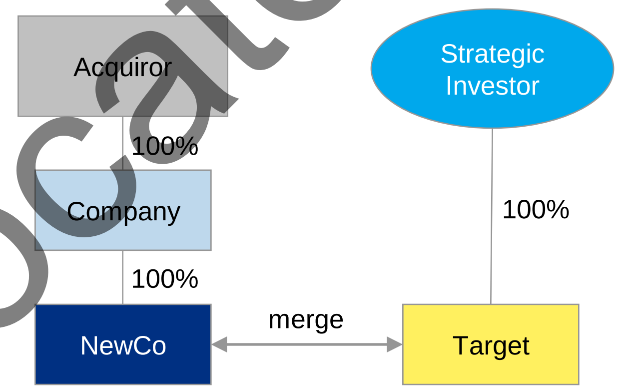


Step 2: Final Structure



Merger / Acquisition

Step 1: Establish NewCo and Merger



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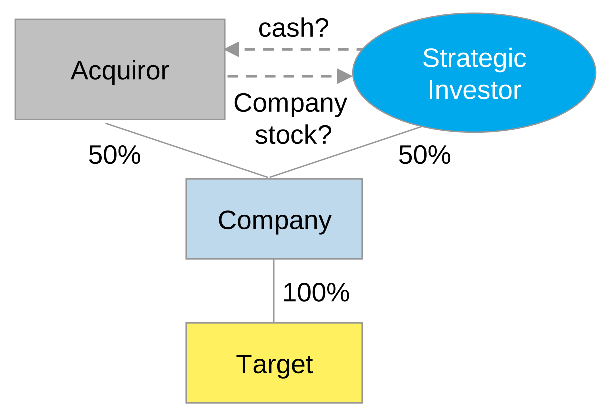
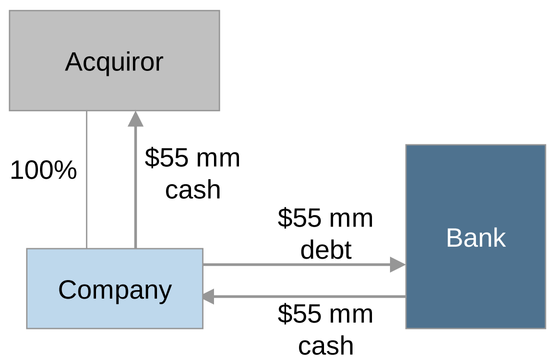


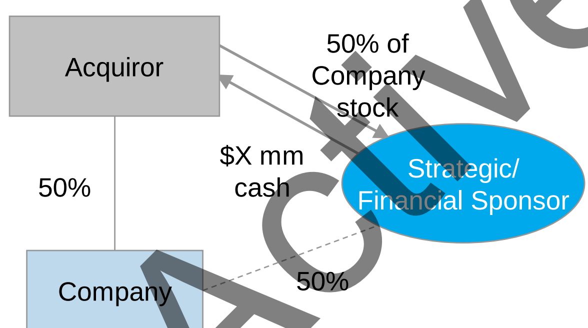
Illustrative Transaction Diagrams (Additional Leverage)

Sell Equity

Step 1: Leverage Company

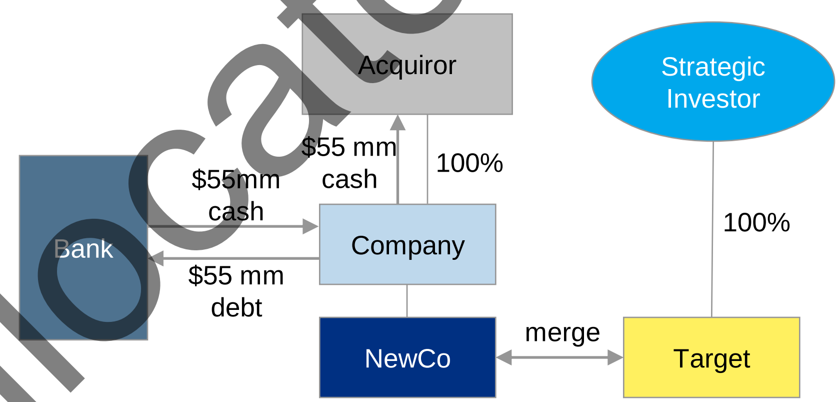


Step 2: Equity Investment

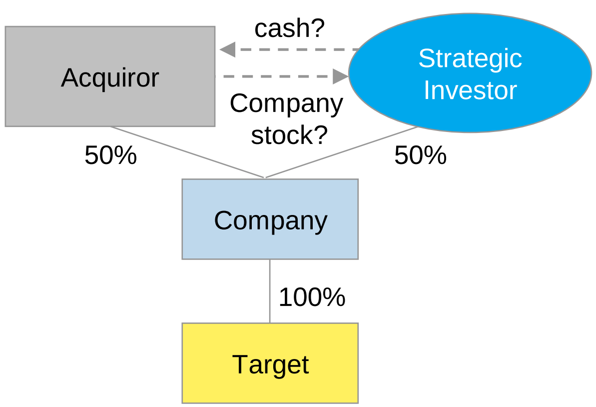


Merger / Acquisition

Step 1: Leverage Company, Establish NewCo, and Merger



Step 2: Post-Merger Structure



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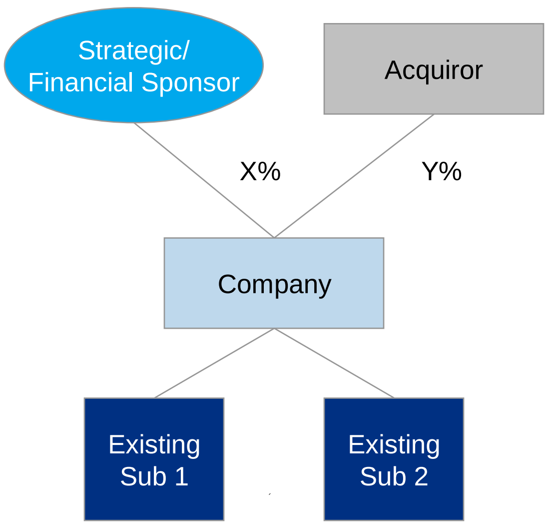
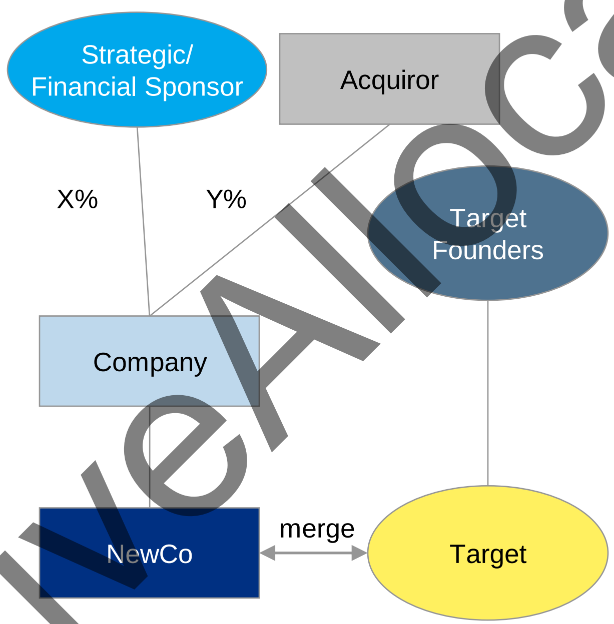
Illustrative Equity Investment by Sponsor / Acq. of Target

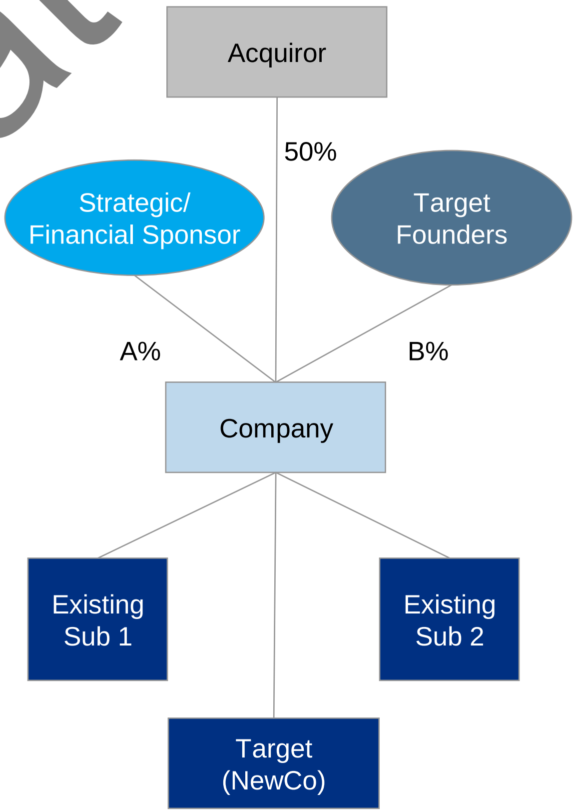
Step 1:
Equity Investment



Step 2:
Establish NewCo and Merger with Target



Final Transaction Structure



Timing

Timing Considerations

- Breadth of process / number of parties invited will be a major determinant of timing
  - More buyers will generally lengthen process
  - Experienced buyers can move more quickly

- Large premium on being properly prepared; significant downside if not properly prepared
  - Need to invest time upfront to develop marketing and due diligence materials

- Concurrent merger and / or acquisition will lengthen process; more data for buyers to digest and synthesize

Preliminary Timetable – Typical Process

Initial Nonbinding Indications of Interest

Selection of Final Bidder

Planning	Marketing	Diligence	Negotiation	Closing
4 - 6 Weeks	2- 4 Weeks	4 - 7 Weeks	3 - 5 Weeks	2- 4 Weeks
• Clarify objectives of sale program • Initiate due diligence, including meeting with management • Develop proposed transaction structure • Develop marketing strategy • Prepare Offering Memorandum • Prepare buyers list • Prepare management presentation • Prepare offering procedures • Begin preparation of draft purchase agreement	• Finalize buyers list • Contact potential buyers • Distribute confidentiality agreements • Deliver Offering Memorandum and offering procedures after receipt of executed confidentiality agreement • Respond to inquiries from buyers • Bidders submit initial indications of interest, including proposed value, terms and financing • Finalize proposed purchase agreement • Set up data room and prepare data room index	• Select limited number of parties based on value, financing, timing, contingencies, due diligence requirements and other factors • Organize final due diligence visits with selected buyers (including management presentation) • Buyers visit data room • Distribute purchase agreement and final bid instructions	• Receive final bids • Analyze bids • Negotiate with top bidders • Execute definitive agreement with selected buyer • File Hart-Scott-Rodino • Announce sale	• Satisfaction of closing conditions

Preliminary Timetable – Typical Process

Initial Nonbinding Indications of Interest

Selection of Final Bidder

Planning	Marketing	Diligence	Negotiation	Closing
4 - 6 Weeks	2- 4 Weeks	4 - 7 Weeks	3 - 5 Weeks	2- 4 Weeks
• Clarify objectives of sale program • Initiate due diligence, including meeting with management • Develop proposed transaction structure • Develop marketing strategy • Prepare Offering Memorandum • Prepare buyers list • Prepare management presentation • Prepare offering procedures • Begin preparation of a draft purchase agreement	• Finalize buyers list • Contact potential buyers • Distribute confidentiality agreements • Deliver Offering Memorandum and offering procedures after receipt of executed confidentiality agreement • Respond to inquiries from buyers • Bidders submit initial indications of interest, including proposed value, terms and financing • Finalize proposed purchase agreement • Set up data room and prepare data room index	• Select limited number of parties based on value, financing, timing, contingencies, due diligence requirements and other factors • Organize final due diligence visits with selected buyers (including management presentation) • Buyers visit data room • Distribute purchase agreement and final bid instructions	• Receive final bids • Analyze bids • Negotiate with top bidders • Execute definitive agreement with selected buyer • File Hart-Scott-Rodino • Announce sale	• Satisfaction of closing conditions