Private Equity Buyers As Divestiture Buyers: U.S. and EU Perspectives

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Private equity sponsors globally have more than $3 trillion of assets under management. They are among the most acquisitive firms and account for a large number of merger control filings. A total of 5,106 private equity-backed buyout deals were announced in 2018 with an aggregate deal value of $465 billion.[1]

Private equity deals in recent years have included a significant number of "carve-outs" – where a unit, division or particular assets were acquired by a private equity fund from a larger company and "stood up" as a standalone business. Bloomberg reports that in the last 10 years, private equity firms have completed more than 460 carve-out deals worth $68.5 billion,[2]including major deals such as Bain Capital's $17.9 billion carve-out of Toshiba Memory Corp., Blackstone's $17 billion carve-out of Thomson Reuters' Financial & Risk business and Carlyle's €10.1 billion carve-out of AkzoNobel's Specialty Chemicals business.

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[1] William Clarke, *Alternatives in 2019*: *A Bumper Year for Private Equity Buyout Deals in 2018 – Will it Continue?, PREQIN (Jan. 24, 2019), available at* https://www.preqin.com/insights/blogs/alternatives-in-2019-a-bumper-year-for-private-equitybuyout-deals-in-2018-will-it-continue/25270

[2] *Four steps to create value in private equity carve -outs*, E&Y (Aug. 23, 2018), *available at* https://www.ey.com/en_gl/growth/how-can-private-equity-create-new-value1enew%20%1evalue.

Notwithstanding this extensive experience, questions have arisen on both sides of the Atlantic whether private equity firms are suitable buyers of divestiture assets. However, this debate has not yielded any factual or legal basis for categorically subjecting private equity sponsors to a more onerous review or conditions. As long as private equity firms satisfy the agencies' current criteria for all types of divestiture buyers, there is no need for enhanced scrutiny or additional conditions.

I. United States

The FTC and DOJ subject all divestiture buyers – private equity and commercial firms alike – to rigorous approval processes. As described in the FTC's Merger Remedies Report, a buyer looking to purchase divestiture assets must: provide detailed financial and business plans to demonstrate its competitive and financial viability; explain how it, and all entities providing financing, evaluated the transaction; and make management, sales, marketing, accounting and other representatives available to staff.[3] The agencies thoroughly vet every divestiture buyer to confirm that it has the incentive and ability to operate the divested business in a way that preserves competition in the affected market. Private equity buyers must provide the same financial and business case information as any other buyer.

Whether private equity buyers should be treated differently has been a recent topic of debate. Over the past year FTC Chairman Joe Simons and FTC Commissioner Rohit Chopra have publicly disagreed about the appropriateness of private equity firms serving as divestiture buyers.

During a September 24, 2018 speech, Commissioner Chopra noted that the Commission may need to ask private equity firms additional questions to determine if they are suitable buyers because "While private equity funds can

[3] Federal Trade Commission, *The FTC's Merger Remedies 2006 -2012, A Report of the Bureaus of Competition and Economics* (Jan. 2017), *available at* https://www.ftc.gov/system/files/documents/reports/ftcs-merger-remedies-2006-2012-report-bureaus-competition-economics/p143100_ftc_merger_remedies_2006-2012.pdf

theoretically create the conditions for a long-term turnaround of the company, their strategies may not necessarily require that the acquired business actually stay in business." He went on to explain that a private equity firm may instead opt to load a business with debt to generate dividends and profits for itself rather than compete fiercely. In his view, private equity firms may also be more likely to exit the investment by selling to a competitor."[4]

Following on this speech, on October 22, 2018 Commissioner Chopra issued the sole vote against the consent decree the Commission reached with Praxair and Linde to divest industrial gas assets to a consortium of Messer Group GmbH and CVC Capital Partners (a private equity sponsor). Specifically, Commissioner Chopra would have imposed additional conditions on Messer Group/CVC Capital Partners' purchase and required prior notice to or approval by the Commission of any asset sales by the buyers in an effort to guard against "opportunistic asset sales."[5]

The next month, in November 2018, FTC Chairman Joe Simons, spoke out against treating private equity buyers as one category and stressed the need to evaluate each potential buyer company-by-company. He went on to note that "There are some really large, well run, well-financed, private equity firms and those, in particular, I would not want to keep out of the process."[6]

There is anecdotal evidence of highly successful private equity acquisitions of assets divested in U.S. merger review processes. For example, in 2001 Nestle acquired Purina and the FTC forced divestiture of Nestle's Meow Mix cat food business line to JW Childs, a private equity firm. Under JW Childs'

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[4] Pallavi Guniganti, *FTC Commissioner hits out at private equity*, GLOBAL COMPETITION REVIEW (Sept. 25, 2018), https://globalcompetitionreview.com/article/usa/1174735/ftc-commissioner-hits-out-at-private-equity

[5] In the Matter of Linde AG, Commission File No. 1710068, Statement of Commissioner Rohit Chopra (Oct. 22, 2018), *available at* *https://www.ftc.gov/system/files/documents/public_statements/1416947/1710068_praxair_linde_rc_statement.pdf.*

[6] Ben Remaly, *Simons defends divestitures to private equity*, GLOBAL COMPETITION REVIEW, Nov. 16, 2018, https://globalcompetitionreview.com/article/usa/1176982/simons-defends-divestitures-to-private-equity

ownership, Meow Mix grew 13% a year and created new products including "hairball formula, a line of wet products packed in pouches, an indoor formula, a kitten formula, a line of cat treats and finally, a line of premium wet cat food packed in innovative plastic cups under the sub-brand, Market Select."[7]

At the same time, there is anecdotal evidence of failures. For example, in May 2013 FTC approved Hertz's $2.3 billion acquisition of Dollar Thrifty Automotive Group on the condition that the combined company sell the Advantage Rent-a-Car to Franchise Services of North America (FSNA), a small rental car operator, and Macquarie Capital, an Australian private equity sponsor that provided funding for the purchase. Just a few months later, the divestiture business (which became Simply Wheelz) filed for Chapter 11 bankruptcy protection. FSNA attributed the bankruptcy to a variety of market, financial and operational challenges.[8] Then FTC Commissioner Julie Brill noted in April 2015 that the Advantage Rent-a-Car buyer failure has informed the way the FTC looks at potential remedies and analyzes the sufficiency of proposed divestiture buyers.[9] However, we have seen no analysis that suggests that the private equity involvement contributed to the failure of the remedy. Indeed, the FTC approved the bankruptcy sale of the bulk of the Simply Wheelz assets to another private equity sponsor.[10]

Beyond anecdote, we have not found any systematic evidence of divestitures to private equity sponsored buyers performing worse than divestitures to commercial firms. As FTC Chairman Joe Simons made clear in November

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[7] Marc E. Babej and Tim Pollak, *The Cat's Out Of The Bag*, FORBES (June 14, 20016), *available at* https://www.forbes.com/2006/06/13/unsolicited advice advertising cx_meb_0614meowmix.html#23a10ce77f81.

[8] Petition Of Franchise Services Of North America, Inc. For Prior Approval Of The Sale Of Simply Wheelz D/B/A Advantage, In the Matter of Hertz Global Holdings, Inc. (Jan. 7, 2014), *available at* https://www.ftc.gov/sites/default/files/documents/cases/140107hertzapplication.pdf.[9]

[9] *See* Leah Nylen, *Hertz -Dollar Thrifty deal has affected how the FTC thinks about divestitures, Brill says*, mLex Market Insight (April 16, 2015).

[10] FTC Approves Franchise Services of North America's Application to Sell Advantage Rent a Car to The Catalyst Capital Group, Inc., Federal Trade Commission (Jan. 30, 2014), *available at* https://www.ftc.gov/news events/press releases/2014/01/ftc approves franchise services north americas application sell.

2018: "Private equity buyers can be very effective in providing both financing and management expertise."[11]

II. European Union

The European Commission (EC) has required divestitures in more than 70 transactions in the last 5 years. While the EC applies to same standard to private equity firms as other potential buyers of divested assets, it often favors strategic buyers with industry knowledge, supporting assets, and a long investment horizon. The EC experience with buyers who turned out to be ineffective has also caused it to increasingly require "upfront buyers," meaning that purchasers of divestiture assets must be approved before the underlying transaction can close. In these cases, there is greater pressure on sellers to find a buyer that will be approved quickly, which may prompt sellers to take an overly-cautious approach and exclude private equity firms from the sales process.

The EC requires merging companies to divest their assets to a "suitable buyer" that will compete effectively with the merged entity and not create competition problems of its own. The key criteria EC looks for in prospective purchasers are financial resources, proven industry expertise, and the incentive and ability to maintain and develop the divested business as a competitive force.

Private equity buyers have been explicitly excluded from acquiring some divestiture assets, on the grounds of lack of sector experience. This is especially the case if the assets are a collection from merging parties' businesses and therefore do not have a track record as a stand-alone business. For example, in the *Ball/Rexam* merger the EC required that the prospective purchaser must have proven expertise in the packaging sector, stating that its market testing "raised doubts as to whether a financial investor (for instance a private equity fund)

[11] *See supra* note 6.

would be a suitable purchaser and have the ability to replicate the competitive constraint that Ball and Rexam exercised on each other pre-Transaction."[12]

However, in its 2005 Merger Remedies Study, the EC acknowledged that private equity firms can be effective owners of divestiture assets: "[i]n the two remedies in the sample involving financial buyers, the remedies were judged effective and their performance in the market was successful."[13] Indeed, the EC further noted that "the shorter term perspective of the financial buyers may well have contributed towards the increased competitiveness of the divested business in the short term."[14] And in one case, "[c]ontrary to some initial concerns, the financial investor proved to be an effective and viable operator and actually managed to increase the turnover of the divested business."[15]

Moreover, in the *Éditions Odile Jacob v Commission* appeals the European courts found that the same standard should apply to investment firms as to other potential buyers. The case involved the EC's approval of the acquisition of Vivendi Universal Publishing, by Lagadère subject to certain divestitures.

Odile Jacob had expressed an interest in acquiring the divested assets but Lagardère accepted an offer by investment firm Wendel Investissement, which the Commission approved. Odile Jacob challenged the Commission's approval of the transaction and of Wendel as a suitable purchaser. In rejecting the argument that the EC had failed to evaluate Wendel´s incentive and ability to maintain and develop effective competition, the Court of Justice noted that "even if a financial buyer does not possess any prior experience in the market concerned, it could retain the existing managers of the entity sold or even equip itself with other skill resources available in the sector concerned."[16] The General Court noted that: "Wendel proved itself to be a viable, capable operator which developed effective

[12] Case M.7567 – Ball / Rexam, decision of 15.01.2016, paragraph 980.
[13] Merger Remedies Study, DG COMP, European Commission October 2005, p. 161.
[14] *Id.*
[15] *Id.,* page 101.
[16] Case C-551/10 P: Judgment of the Court (Grand Chamber) of 6 November 2012 — Éditions Odile Jacob v Commission, paragraph 78.

competition on the market […]. It is common ground that [the divested business] experienced significant business and growth after its purchase by Wendel, allowing Wendel, in May 2008, to resell it to Planeta, which the applicant could not claim effectively weakened competition on the market."[17]

III. How Can Private Equity Buyers Best Position Themselves as a Suitable Purchasers?

To best position themselves for success in the regulatory vetting process, there are several actions private equity sponsors can take.

- Have counsel engage with authorities as early as practicable, to ensure a good understanding as to the expectations regarding the capabilities of the purchaser.
- Demonstrate a track-record of successful growth of portfolio companies, especially carve-outs. Successful prior investments in the subject industry or closely related ones are particularly important.
- Be prepared to explain any failed investments.
- Ensure that the business plan includes details of the growth plan for the business, and how it will meet debt obligations under various scenarios.
- If it makes sense from an investment and business perspective, partner with an commercial company from a relevant industry, and have that partner participate actively in the approval process.
- Include in your diligence and planning team seasoned operating executives from the relevant industry, and involve them in your interactions with the antitrust authorities.

[17] Case T -471/11: Judgment of the General Court of 5 September 2014 — Éditions Odile Jacob v Commission, paragraph 141.

- Be prepared to provide as much detail as possible about how you will operate the divested business, including identifying key executives who you expect to lead it. Management retention and incentive plans are helpful.

- Have a clearly articulated view as to whether any additional assets are required to ensure the success of the divested business, and what transitional arrangements will be needed while the business is being stood up.

- Be prepared to explain the expected hold period, and the exit strategy (e.g., IPO, strategic sale).

Now more than ever, there is a premium on being well-prepared to engage with sellers and regulators early in the process to be positioned as a "suitable buyer." Since the divestiture assets are often valuable businesses that would not ordinarily come on the market, the effort can be well worth it.