LATHAM&WATKINS

PE VIEWS

OUR INSIGHTS ON THE WORLD OF PRIVATE EQUITY

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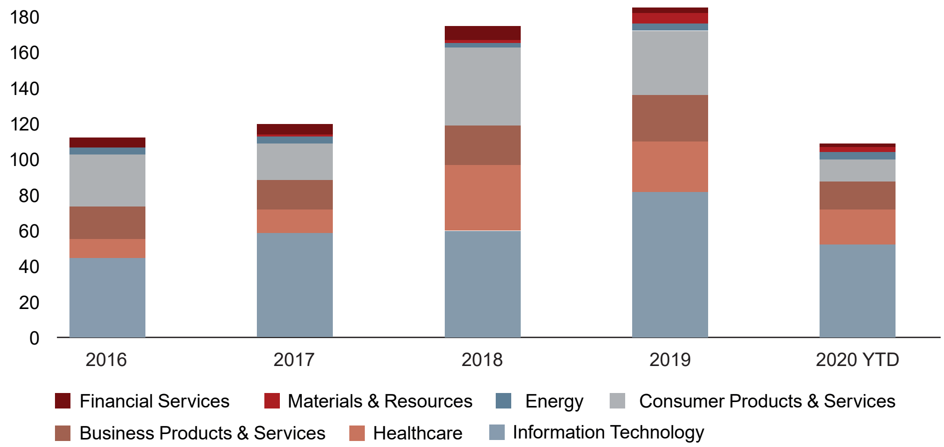
The Rise of Growth Equity — Connecting PE and VC

Emerging companies have historically been backed by venture capital funds, but as Europe's startup scene matures, involvement by more traditional private equity investors is growing, particularly in the tech, consumer, and digital health sectors. The number of PE investments in emerging companies has increased year on year, with investments in companies such as Wolt, Moonbug Entertainment, Zwift, Klarna, Epic Games, and Oatly demonstrating the range of opportunities available to PE sponsors in this space. While PE investors are increasingly familiar with VC deal dynamics, they are also pushing to align growth-deal terms more closely with traditional buyout concepts.

PE Investor Led VC Deals by Industry Sector



Source: PitchBook

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Relinquishing Control

Investors typically invest in a growth company as a minority investor at the top of a stack of existing institutional investors, meaning they are unable to exert the level of control usually seen in buyout deals. One board seat and a limited set of reserved matters are likely to be the limits of their influence. Alignment with fellow investors is therefore an important dynamic, and something that we are seeing deal teams consider at the outset of the transaction.

Investors also need to potentially get comfortable with founder management holding the balance of power and influence. Unlike a traditional buyout, where the sponsor has control, founders will not want, or expect, to relinquish control to financial investors. In most cases, one or two founders will be responsible for all of the key decisions, subject to a set of reserved matters.

A lack of control over exit is another concern. PE investors are used to being able to control an exit through majority voting (at both shareholder and board level), and ultimately through drag rights and unilateral IPO trigger rights. Minority investors in emerging companies, on the other hand, will typically need the support of other investors to exercise a drag and typically lack an IPO trigger. Recent deals have shown that founders frequently control the exit, with minority investors granted at most a blocking right if anticipated returns fall below a certain threshold.

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Meeting in the Middle

As PE investors seek growth equity investments, we are now seeing increased convergence between typical PE buyout and emerging company deal terms. While venture capital investors typically expect a non-participating liquidation preference (i.e. the option to have their money back in priority to the ordinary share return, or to participate pro rata in the ordinary share return), PE sponsors are going one step further to protect themselves in a downside scenario by requesting a participating preference (i.e. their money back in priority, as well as pro rata participation in the ordinary share return) or coupon accruing on the preference return. PE sponsors are also exploring a right to have their shares redeemed if an exit has not occurred by a certain date, to provide the exit certainty that they are lacking in the VC construct.

There is also a push to introduce more robust governance rights and structures. For example, PE investors have sought the right to remove founders from the board if their conduct brings the company into disrepute. In light of recent high-profile controversies, sponsors are keen to mitigate reputational risks associated with bad founder behavior, though this type of protection continues to be hard-fought.

PE sponsors require more robust compliance to fulfil their internal requirements and prepare the business for an IPO. Though founders can be reticent to spend the time and cost, ultimately they often welcome the assistance of a PE sponsor in this regard.

Our view is that venture and more traditional PE industry terms will continue to converge, but PE sponsors will still need to be very sensitive to the expectations of founders when investing in growth targets.

CMA Clamps Down on Deals — Navigating the UK's Increasingly Interventionist Merger Control Regime

Dealmakers must be alert to the increasingly interventionist approach of the UK's Competition and Markets Authority (CMA), including on transactions with a limited nexus to the UK. Until now, the European Commission has acted as a "one-stop shop" for large-cap transactions. But the end of the Brexit transition period means that from the start of 2021, acquirers may face parallel EU and UK investigations — with the effect that the CMA will play a more prominent role in reviewing global deals.

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This is likely to increase the regulatory burden on acquirers, including for non-problematic cases, since the CMA has no equivalent to the EU's "short form" procedure allowing for a more truncated and less burdensome notification in simple cases. Further, for potentially problematic cases requiring remedies, differences in process and the need for regulatory buy-in are likely to create challenges in ensuring that remedy offers can successfully straddle the EU and UK systems effectively.

The CMA's increasingly interventionist approach has resulted in an increase in the number of cases being referred for an in-depth investigation

Brexit and an Expansive Approach to Jurisdiction Brings More Deals In-Scope

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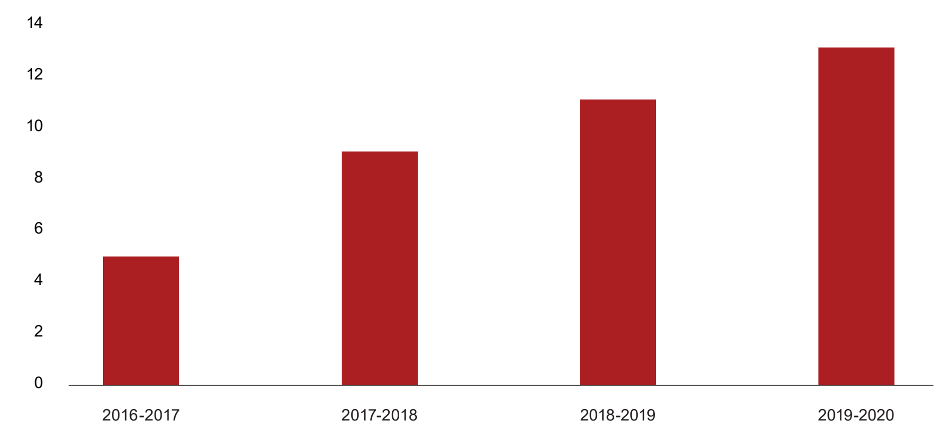
CMA's Increasing Phase 2 Referral Rate — Number of Deals



Source: CMA Merger Inquiry Outcomes

The CMA believes that it may need to review up to 50 additional notifications each year as a result of Brexit. The increase in workload is also the result of the CMA taking an expansive approach to jurisdiction. Cases such as Sabre/Farelogix and Roche/Spark demonstrate that the CMA is making dynamic, forward-looking assessments of parties' overlaps, even in cases in which the target had no revenues directly attributable to the UK. Further, the CMA can and often does investigate acquisitions of "material influence", such as E.ON/RWE and Amazon/Deliveroo, both of which involved influence being conferred by a circa 16% shareholding.

Use of Initial Enforcement Orders Poses Challenges for PE

In the UK there is no requirement to obtain clearance prior to closing. However, the CMA's powers give it considerable leverage to investigate deals that are of interest to it. Indeed, the UK's "voluntary" merger regime operates increasingly like a mandatory regime, not least because of the CMA's use of hold separate orders or Initial Enforcement Orders (IEOs). The "quasi-mandatory" nature of the UK regime means that acquirers will have to make difficult judgment calls in relation to filing strategy in the UK. The CMA will invariably impose an IEO on any completed transaction that it investigates.

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From a PE perspective, the key takeaway is that the starting point is for an IEO to apply to all global operations of the entire organisation. In the case of a typical private equity acquisition structure, that would now include the newco stack, the investing fund, affiliate funds, and advisory entities. An IEO freezes any further integration of a completed transaction, and may even require that any integration that has already taken place be reversed. The order also places significant restrictions on the acquirer to "preserve the competitive structure of the market".

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Derogations can be agreed and accepted in advance to ensure that the operative provisions of the IEO only extend to the overlapping portfolio company(ies) and the actual acquiring fund. However, this process can take time, is subject to negotiation, and the CMA does not always accept requested derogations.

While the new environment is challenging for acquirers, deal teams can mitigate the risks, and early engagement with the CMA is vital.

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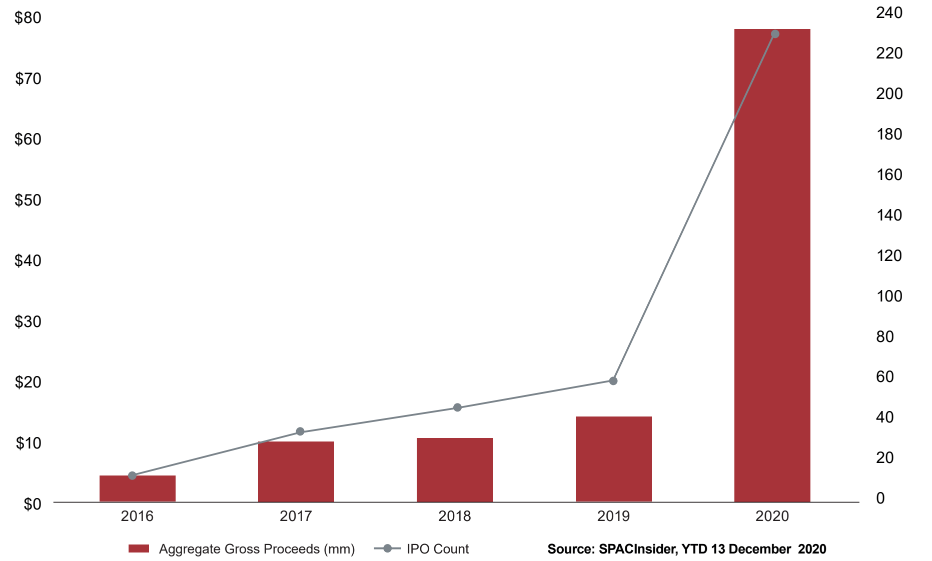
Securing a Successful SPAC Sale — What PE Firms Need to Know

Special purpose acquisition companies (SPACs) have emerged, somewhat unexpectedly, as the hottest market trend in the US this year, allowing SPAC sponsors to launch shell companies with the goal of taking private companies public via merger. SPACs are rare in Europe due to regulatory constraints — a SPAC acquisition is a deemed reverse takeover, likely to result in the SPAC's shares being suspended and/or cancelled, with the enlarged group only readmitted following publication of a prospectus.

US SPAC Activity



Source: SPACInsider, YTD 13 December 2020

With nearly 200 US SPACs seeking a business partner, PE sellers are taking note

However, US SPACs offer a direct pathway to the equities markets. With nearly 200 US SPACs seeking a business partner, PE sellers are taking note. We believe these vehicles can offer an attractive exit route for European PE portfolio assets.

SPAC as Monetization Alternative

For PE sellers, taking a portfolio company public by merging it with a SPAC can be a faster, cheaper process compared to a traditional IPO, and can allow the sponsor to preserve upside by retaining shares in the public company, like an IPO. Because the SPAC has already gone through an IPO prior to seeking a merger counterparty, SPAC mergers help avoid market timing issues and the risk of a deal falling down due to volatile conditions — a commonly encountered issue, particularly this year.

Taking a portfolio company public by merging it with a SPAC can be a faster, cheaper process compared to a traditional IPO

A SPAC transaction is generally not a complete exit. In most cases, deals are not structured as full cash-out sales and PE firms are frequently locked up, unable to sell shares for a period post-closing. Even once that period expires, sell downs will be made in accordance with a registration rights agreement, aspects of which are heavily negotiated. Accordingly, PE firms should plan for a structured and longer-term sell down.

However, for portfolio companies seeking growth capital, SPAC sales can be particularly advantageous by allowing them to raise funds via a private investment in public equity (PIPE), in addition to the cash available from the SPAC's trust account.

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Key Attributes for Success

Many traditional investment document concepts such as "Qualified IPO" and "Liquidation Event" do not contemplate the unique structure and considerations associated with going public by combining with a SPAC. It is therefore important that the portfolio company's financing documents and management equity documents are carefully reviewed to determine how they will operate on an exit via a SPAC IPO.

PE sellers must also ready their portfolio asset for the public markets. While a SPAC may offer a strong valuation, target portfolio companies should take steps to prepare to operate as a listed business. This means ensuring that the right administrative and governance structures are in place (i.e. financial reporting, internal audit, and a general counsel's office).

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As with any exit, PE firms should consider maximising their options by running an auction process. Recent successful auction processes have involved soliciting term sheets and indications of valuation from multiple SPACs, or distributing a letter of intent to which SPACs respond — although sellers should be mindful that the ultimate value of the listed company is frequently determined through the PIPE process, as institutional investors indicate the value at which they are willing to participate. Deal teams should expect a thorough diligence and price discovery process, with both the SPAC counterparty and the PIPE investors.

Deal structure and ongoing governance expectations also require consideration. SPAC sponsors expect some level of board representation, and PE firms should be prepared to consider dual-class shares, shareholder consent rights, and other structures, for the PE firm's benefit as a majority (or near majority) owner of the public company.

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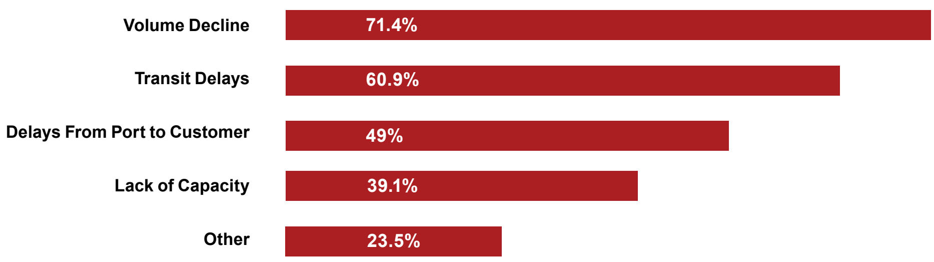
Keeping Up With Innovation

As PE sponsors consider options for monetizing portfolio company investments, going public through a business combination with a SPAC has rapidly become a viable alternative to a traditional IPO, direct listing, or outright sale. As deal terms evolve in this growing sector, sponsors must remain apprised of current market terms and remain nimble to maximise the opportunities available.

Scrutinising Supply Chains — New Tools for PE

Global supply chains have come under significant pressure in recent years, compounded by the effects of this year's pandemic and shifting global policy agendas. In our view, supply chain analysis and management will remain critical for sponsors in the coming year as they seek to avoid risks including reputational damage, loss of revenue, and loss of goodwill. Performing diligence on a target is no longer enough — rather, the target's value chain and broader supply chain require careful analysis to determine resilience and uncover risk areas, but such review can also identify opportunities.

COVID-19 Pandemic's Consequences for Global Supply and Freight Chains in 2020



Source: Statista Shipping & Freight Resource; Ocean Insights

Recent Challenges

Prior to the pandemic, increased regulation in China led to factory shutdowns across the country, causing challenges for many international supply chains. Trade wars have also presented operational issues, with many companies considering reshoring or shortening their supply chains.

In the UK and other jurisdictions, supply chains have been under increased media and regulatory scrutiny. The recent government review of the UK's Modern Slavery Act found many companies were not compliant with the legislation, and suppliers were brought into media focus this year following the exposure of illegal labour activities in the UK.

Heightened investor and consumer focus on environmental, social and governance (ESG) issues has also increased public scrutiny of portfolio company supply chains and their oversight by PE firms.

A New Approach

Supply chain diligence is becoming an integral part of the deal process, and deal teams are embracing new technology to help identify supply chain risks on a broadening spectrum of transactions. Tools such as *RiskHorizon* (which Latham has helped develop) are being used to benchmark a target's operations against wide-ranging ESG data, identify supply chain risks, and obtain tailored due diligence recommendations. Further, a growing number of companies are using other new technologies, such as smart devices and blockchain, to enable transparent and end-to-end tracking in many sectors, including minerals and cosmetics.

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Aside from these innovations, portfolio companies should consider what legal protections are in place across their supply chain. Having focused on force majeure and termination-related clauses earlier in the year (to determine provision for lockdown-related scenarios or sudden changes in contractual performance), as the economic crisis develops the spotlight is now shifting to include the risk of customer distress. Where a target is a supplier, the implications of recently enacted legislation restricting termination and other contractual rights if a customer enters one of several UK restructuring or insolvency processes, require review.

Obtaining a Strategic Advantage

We expect supply chain issues to be a continuing area of regulatory, investor and consumer focus. Multiple jurisdictions, and the European Commission are seeking greater corporate accountability on a growing range of supply chain topics, including labour infringements, human rights and deforestation.

While many will focus on risk management, in our view, effective supply chain analysis of a target can be viewed as an opportunity to gain a strategic advantage. A strong understanding of value drivers, vulnerabilities, and areas of improvement at the center of a business' operations (and that of its competitors) can enhance value and performance in times of disruption.

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