Introducing Full Equity Backstops to the PE Toolkit

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As competition for deals remains heated, full equity backstops have become a useful option for sponsors willing to be aggressive to distinguish themselves in auctions. Agreeing to a full equity backstop can give a sponsor a leg up on other sponsor bidders and put the sponsor on equal footing with strategic buyers in the seller's consideration of deal certainty. We saw an uptick in the use of full equity backstops in 2017 and expect that trend to continue in 2018. However, potentially having to fund the entire purchase price with equity raises a number of considerations.

Background

Under the traditional deal model, sponsors commit to fund a limited equity contribution in the event debt financing is available and guarantee payment of a reverse termination fee in the event debt financing is not available. In providing a full equity backstop, however, the sponsor commits to fund the full purchase price. Full equity backstops came to prominence with Vista's $4.2 billion take-private of TIBCO in 2014. Vista never intended to fully fund the transaction with equity (it secured debt financing commitments the day after the acquisition agreement was signed), but the additional closing certainty that its bid contained helped Vista win a hot auction. At the time, Vista's use of a full equity backstop in such a substantial deal raised eyebrows among practitioners. Although full equity backstops have become more common in the past few years, they remain most often seen in smaller- to middle-market deals.

Fund Restrictions

One gating item a sponsor should consider is whether its fund documents permit use of a full equity backstop for a given deal. Diversification limits can render full equity backstops more suitable for use in a sponsor's smaller deals. Fund documents do sometimes provide for higher concentration limits to the extent bridge equity is used in a deal. This provision can be useful in the context of a full equity backstop, since a sponsor will typically seek not to fund the entire purchase price with equity and, if forced to do so, would intend to refinance much of the equity with debt as quickly as possible following closing. These bridge provisions in fund documents raise numerous considerations, including how the bridge financing will be treated from a carried interest waterfall perspective, how the bridged amount will impact track record and IRR reporting and whether the bridge capital can be "recycled" for use in subsequent investments.

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Fund-Level Debt as an Alternative

In a scenario in which a sponsor is not able to obtain debt commitments to support a full equity backstop, but a fund-level debt facility is available, that debt facility can be used to finance the "equity" required to be funded. A sponsor must consider whether there is sufficient capacity under the fund-level facility, how quickly the funds can be drawn and how long borrowings may remain outstanding. Fund-level debt facilities have become common among sizable sponsors. (For more on this, see https://www.debevoise.com/insights/publications/2017/07/fund-finance-focus-dont-neglect.)

Damages Caps

Although the seller will have the ability to seek specific performance of the sponsor's full equity backstop, the sponsor will typically seek a cap on a potential damages claim equal to an amount lower than the purchase price. Sponsors are often successful in obtaining these caps, which can be in the range of a traditional reverse termination fee or higher (*e.g.*, 10% or 20% of the purchase price). A principal rationale for imposing a cap on damages is to deter sellers from opting for a damages remedy for breach in lieu of specific performance.

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Takeaways

With auction dynamics continuing to tilt in favor of sponsors who can distinguish their bids by providing speed and certainty of closing, we expect focus on full equity backstops to only increase. Sponsors who might consider agreeing to a full equity backstop in a future deal should become familiar with the technology, including the interplay with the sponsor's fund documents and any fund-level debt facility that may be in place.

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