The Deal

REPRINT FROM AUGUST 7, 2006 P. 23

LIFE SUPPORT

AS THE PE MARKET BEGINS TO TOP OUT, INVESTORS SHOULD PAY MORE ATTENTION TO SO-CALLED CRISIS BRIDGES

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Today we are on the verge of another market decline—particularly in the private equity and venture markets. In the past year, these markets have been characterized by irrational investor exuberance. Value funds are dropping out of auctions. Winning bidders are substantially increasing aggregate debt leverage. This is a harbinger that we're nearer the end, rather than the beginning, of a market cycle.

As the purchase prices paid for both early-stage venture and more mature corporate assets reflect higher multiples of Ebitda or revenue, management's financial projections used in connection with capital raising have a very human tendency to similarly increase. If the entity's future doesn't look increasingly rosy, then there will be no way to demonstrate an ultimate liquidity event at a sales price large enough to create the expected high internal rate of return.

In the next six to 12 months, funds will find that the companies for which they paid irrational purchase prices within the past two years may be on the edge of failure. Before then, investors and stakeholders will engage in concerted attempts at capital and corporate preservation.

The move to protect stakes and preserve corporate assets in the coming quarters will prompt a significant upturn in what I term as internal "crisis bridge financings"—much like what the venture capital world lived through in the fourth quarter of 2001 and most of 2002.

These crisis bridges will be used to keep a struggling company alive long enough to slash costs and radically revise the original business plan; raise significant capital at an acceptable price; or simply sell the company at anything other than fire-sale pricing.

In all crisis bridge financings, bridge investors will seek collateral and economic rights that are highly attractive and generally superior to the rights of existing security holders and classes or series of prior debt and equity financings.

When there's a single investor, then only a limited number of participants must reach agreement to waive or modify their existing contractual rights to subordinate them to the bridge financiers and produce a revised capital structure that accommodates changed facts and capital circumstances. A negotiation can occur, and compromise and agreement reached, because a small group of motivated individuals have the capacity to do so unilaterally.

But the norm in today's world is multiple rounds of financing, syndicated groups and different types of investors, in each separate round. This complicates and slows matters—when speed is the utmost imperative for a successful bridge. Each additional vote required, or consent needed (whether from inside investors or outside stakeholders), decreases the probability of a successful bridge. Complicating matters are that institutional and individual high-networth investors have different decision-making processes, risk-reward analyses, and negotiating perspectives. These factors elongate the time and process required to create, finance and document consensus.

Thoughtful investors must consider the probability that modifications to charter documents and shareholder rights agreements may occur

during the turbulent and emotionally charged circumstances in which crisis bridge financings occur. The same documents that are negotiated at the outset cannot fulfill all needs or anticipate all circumstances in which decision-making occurs. Protective provisions look and function differently during "normal" operating circumstances and liquidity events than they function in "troubled" environments.

Understanding that bridges may be required, however, may make an investor consider certain provisions differently. For example, while certain protections are provided by supermajority requirements, the higher the approval requirement, the less flexible documents will be if modifications are required for a crisis bridge, particularly if the supermajority vote is required in multiple rounds of financing. In lieu of investor votes, consider letting highly qualified, designated investors serve as the practical proxies for all institutional holders in a round because they share a similar investment orientation, thought process, and fundamental needs as investors. And never, under any circumstances, have a requirement of unanimity if there are more than a few investors. It's simply too hard to achieve.

Finally, consider permitting a series director to vote on modification and bind the entire series for which they are the elected director. This may be more appealing than conducting a full vote of the affected series or class and obtaining approval from other shareholders who probably have less current knowledge about the business than the representative director.

The lesson may be that private equity investors should modify their perspective and not insist on the last degree of control obtainable. Less may truly be more. Permitting business judgment to be exercised by a smaller group of individuals could be the only process that will permit victory to be snatched from defeat. Ultimately, expanding the universe of actions requiring investor approval may ultimately create tomorrow's "loss" when cumbersome, excessively controlled structures may create self-defeating loss of time. That is the definition of Pyrrhic victories. ■

AS FEATURED IN

The Deal

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The Deal (ISSN 1541-9878) is published weekly except biweekly in January, July, August and December by The Deal LLC.

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