Evolving negotiation strategies in late stage PE investments

Fund raising by late-stage firms has become sophisticated, with many founders opting to run a bid process, on the back of a proven track record of performance, ethics

Shreyas Bhushan

Founders of late-stage companies are extremely sensitive about giving any rights to investors that fetter their ability to run the firm as they have done so far. Photo: iStockphoto

Private equity (PE) investments into India are at an all-time high, with more than $11 billion invested by PE funds in 2017. The keenness now is more towards late-stage companies as compared to growth and venture investments. Fund raising by these late-stage companies has also become sophisticated, with many founders opting to run a bid process, on the back of a proven track record of performance and ethics. As a result, we have witnessed conventional PE deal making surrender to a more risk-partnership style of deal making, when negotiating on behalf of late-stage companies and founders. This article summarizes a few of those changes that mature investee companies are able to negotiate against PE investors who take non-controlling positions in such companies.

Firstly, PE investments in India have traditionally been guided by the standards adopted in the venture capital (VC) space. As a concept, late-stage companies are opposed to any notion of preferred equity and regard PE investors as pure play risk partners. Hence, as a starting point, the rights package (such as board representation, veto rights etc.) provided to such late-stage PE investors is discernibly different and limited, when compared to VC investments.

Secondly, a major difference in negotiations is the shift in approach while dealing with affirmative or veto rights. The conventional approach of PE investors to stay clear from the operations/management of their portfolio companies, but continue to keep the promoters in check through a long list of veto matters, may not work with late-stage companies.

Having exhibited a proven track record, founders of late-stage companies are extremely sensitive about giving any rights to investors that fetter their ability to run the company as they have done so far.

Hence, there may be stiff resistance to the “standard investor protection matters” such as fund raising, leverage or even on the business plans.

As a midway, such late-stage companies may move towards being board-controlled entities (as opposed to shareholder-controlled entities) with a few independent directors to ensure sanctity of the board.

Thirdly, investor protection matters like anti-dilution protection and liquidation preference are becoming uncommon in late-stage deals. Similar to the commonly accepted concept in the West (called “pay-to-play”), founders of late-stage companies argue that there should be no reason for the founders to compensate the investor in case of a down-round or prioritize payments to the investor in case of a liquidity event. Each shareholder should equally partner in risk, and the founders should not be made to compensate for the loss in value of the investors, unless it is established that the founders have acted in bad faith, committed fraud etc.

On the same principle, founders are also reluctant to provide personal indemnity to investors for business related representations/covenants (except for fraud etc.), since the investors are presumed to have taken an informed call based on the information provided about the company/founders.

Similarly, when it comes to exit scenarios, founders of late-stage companies are seen to resist taking up an unconditional obligation to cause an exit providing public offering, and an IPO on “best efforts basis” by the founders is often agreed. Accordingly, investor rights such as drag along/put option rights are also rarely insisted in case the IPO does not happen as contemplated. Instead, a “strategic sale” of the company is agreed upon as the last exit option, where both the “founders” and the “investor” will jointly appoint a banker for sale of the company (or sale of a controlling stake), thereby introducing an element of fairness to the process.

Lastly, an interesting concept of founder re-ups is also emerging. In such cases, the founders may agree to give up certain rights in favour of the investor so long as the promoter is compensated appropriately in case the company outperforms its projected estimates.

All-in-all, PE deals are no longer bound by the ostensible “standard practices” of the industry, and with too much capital chasing too few deals, founders of late-stage (typically $500 million valuation), ethical and professionally run companies have the edge. Having said that, in our experience, investors who offer a significant value proposition—such as customer/supplier relationships, industry expertise, patience to hold the investment etc.—are also capable of successfully negotiating the “standard positions” with mature corporates.

Considering the massive growth potential of Indian companies, PE investments will surely continue to increase. However, deal making contours will ultimately be defined by two important factors—who benefits more from the partnership, and what really is the walkaway threshold.

Shreyas Bhushan is member, PE and M&A practice, and Ruchir Sinha is head, PE and M&A practice, at Nishith Desai Associates.