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Private equity: Are you ready to go clubbing versus single-investor deals?

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Across the globe, the last half decade or so has seen a significant shift in trend towards club deals compared with traditional single-investor deals. The advent of club deals in the Indian market is a more recent phenomenon, but it seems to be gaining significant momentum.

According to publicly available data, of the 222 deals (worth around $5.1 billion) consummated in 2011, 63 were club deals (worth around $2.5 billion). In fact, an interesting observation was that a large portion of these deals were in the mid-size segment.

Some of the recent popular club deals in India include: the $1-billion investment in Bharti Infratel by a consortium of private equity investors, including Temasek Holdings, Goldman Sachs, Investment Corporation of Dubai, Citigroup and India Equity Partners and the $140-million residential development platform set up by Godrej Properties and foreign investors, including Dutch Pension Fund and APG.

A club deal is nothing but an arrangement where multiple investors, typically private equity firms, pool their assets together to make an acquisition or an investment, which may or may not result in the investors acquiring a controlling interest in the investee entity.

The obvious advantage of a club deal is that investors, owing to their pooled funds can acquire significantly larger stakes in smaller to mid-size targets than what they could have done individually.

With each investor taking a relatively smaller bet, the risk attached to making investments is also mitigated to a significant extent in club deals. Of course, whether collectively holding a controlling interest is a boon or a bane would depend on the dynamics and potential conflict of interest, inter se the investors.

Certain practical issues such as appointment of multiple advisors, extended multi-dimensional negotiations increase the overall cost of funds associated with club investments.

Some recent developments like the inclination to have common advisors and the election of lead investors has helped address this issue. Lead investors have been seen to take on different roles ranging from simply getting a larger chunk of the rights inter se the investors (owing to bringing in the largest sum of money) to taking on an active role in the management / operations of the target, even though their relative investment amount may not be that significant.

However, knowing and accepting early enough as to who is in the driver's seat is essential not only from the perspective of consummating the investment, but also from the point of view of getting a smooth exit.

Club investors coming from different geographies face tricky situations while investing in India. For example, European investors may prefer the use of Netherlands or Cyprus as an intermediate jurisdiction, whereas non-European investors may have a preference for Singapore or some other jurisdiction.

A common situation faced in such deals is from an exit perspective, where different funds look at different horizons for exit from a given investment, depending on their respective fund life.

Another important issue to carefully address is that investors may, under applicable domestic tax laws, be considered as an 'association of persons' depending on the nature of the club arrangement, which may severely impact the returns of the investors. Club members should also consider key legal issues ideally before entering into negotiations.

Inter se exclusivity terms, subsequent round investment rights, availability and extent of veto rights, nuances of transfer restrictions such as ROFRs and ROFOs, as well as governance rights/ board representation, which may not necessarily be proportionate to investment size, are some of the big-ticket items.

It appears that club deals have advantages for investors, albeit with certain challenges, but their impact on existing shareholders of the target needs to be looked at closely.

Such shareholders are confronted with a two-edged sword - while they can richly benefit from the vast experience and different dimensions of value creation that multiple investors can bring to the table, club deals decrease competition and with fewer overall investors for the target stake.

There are ample arguments on either side and it appears that the trade off for the seller lies in determining whether the value creation can offset the reduction in valuation.

Considering it is apparent that club deals are here to stay, it is in the interest of all stakeholders to timely iron out the challenges and issues surrounding such deals and strike the right balance between their respective interests.