PE VIEWS

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Creative Uses of Collateral Present New Financing Opportunities for PE

Raising fresh capital for portfolio companies in times of financial stress is always a delicate balancing act between attracting new lenders and maintaining the strategic support of existing creditors. The almost instantaneous halt in cash flows and scramble for new capital injections precipitated by the COVID-19 pandemic has significantly changed traditional approaches to collateral — giving rise to new financing opportunities for sponsor-backed deals and businesses. Regardless of debt market buoyancy, these new financing techniques are here to stay, having demonstrated value in overcoming creditor scepticism during times of economic uncertainty and bringing a new way to increase leverage.

The COVID-19 pandemic has significantly changed traditional approaches to collateral

JCrew 2020?

In recent years and prior to the COVID-19 pandemic, the typical blueprint for emergency fund raising had been the "JCrew" financing technique, through which assets are shifted to an unrestricted subsidiary and pledged to new money providers. However, the JCrew technique has taken on markedly negative connotations for frequently rattling debt investors (by removing valuable assets from the original credit support package) and ultimately resulting in disputes. So perhaps unsurprisingly, bondholders revolted when sports car company McLaren addressed its pandemic related liquidity shortfall by seeking to use an unrestricted subsidiary to raise debt against its head office and heritage car collection.

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A More Consensus-Driven Approach

In response, we are now seeing borrowers shore up their balance sheets and raise capital on a less confrontational basis, without compromising the allegiance of debt markets.

This has been achieved by revisiting the concept of "permitted lien" or "permitted security", utilising an explicit but overlooked permission commonly included in financing documents to take unencumbered assets that are not already pledged to existing creditors as collateral for securing new funding. Although this permission tends to be narrower than the capacity allowed for unrestricted subsidiaries, it is unquestionably intended for the purpose of raising incremental secured finance. The unassailable legitimacy of this approach puts it well beyond the criticism or risk of legal challenge directed at the more controversial JCrew technique, bringing greater certainty.

Using this approach, Great Stirrup Cay, a Bahamas idyll, gave investors comfort to buy almost US$700 million of Norwegian Cruise Lines bonds — heralding what would soon appear as a broader trend. With a sufficient loan-to-value ratio, borrowers discovered that they could raise cash and keep businesses afloat by pledging all sorts of unencumbered assets — from idle ships and airport landing slots to Caribbean real estate and frequent flyer miles.

ASDA 2021

The buyout of UK supermarket chain ASDA illustrates the growing importance and wider application of innovative asset-based lending. The deal, primarily funded by the largest ever Sterling bond issuance, was underpinned by additional slices of debt secured over real estate collateral. In addition to standard LBO financing, ASDA's buyers were able to parlay noncore assets (forecourts and distribution centres) into stand-alone collateral to raise several strips of interim financing, bridging to the eventual sale of the assets making up the stand-alone collateral.

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This creative approach to takeover finance struck the right balance by allowing the buyers to increase leverage beyond the typical boundaries of leveraged lending, without alarming debt investors. On the contrary, the £2.75 billion bond sale was oversubscribed and priced at very tight levels.

Application to Other Deals

To tap into new financing opportunities, PE dealmakers must creatively scan a target or portfolio company's asset base for pools of liquid collateral that can be detached (which can include a lease back, where necessary) from the business without affecting long-term prospects.

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Preparation is key — dealmakers should work with legal counsel to review financing documents, prepare asset reports, and produce in-depth structuring papers that credibly spell out the monetization potential and viability of a quick sale of the identified assets. As the ASDA deal demonstrates, markets will give a fair hearing to investment propositions that ring-fence the security offered to mainstream investors from the collateral set aside for incremental specialty finance.

Pandemic Underlines Whistleblowing Risks for PE

As global businesses react to the pandemic and social movements, PE firms should remain watchful for whistleblowing issues involving both portfolio and target companies. We anticipate a significant increase in the number of employees asserting whistleblower status — a development that may prove costly to address, even if claims are without merit.

In an economic environment where redundancies are increasing and the new jobs market is depressed, employees are more likely to resist termination

There is now more to blow the whistle about, including new workplace health and safety issues arising from COVID-19, misuse of government furlough schemes, and events highlighted by movements like #BLM and #MeToo. This is in addition to long-standing whistleblower issues, such as accounting irregularities, anticompetitive behaviour, and bribery and corruption. Further, in an economic environment where redundancies are increasing and the new jobs market is depressed, employees are more likely to resist termination.

What are the implications of asserting whistleblower status?

Employment jurisdiction typically determines the detail of what whistleblower status means in practice. In the US, federal and state law provide a plethora of whistleblower protections. Monetary awards from regulatory bodies provide a powerful incentive to eligible individuals who report violations. While UK regulators do not reward whistleblowers for tip-offs (and it would be rare for employers to do so), whistleblowers have enhanced protection against dismissal if they make a protected disclosure in good faith (see box below), even if the allegations ultimately prove unfounded.

WHAT DISCLOSURES ARE PROTECTED IN THE UK?

A disclosure is "protected" if it is made in the public interest and to a certain category of person (e.g., the worker's employer or certain regulators), and the worker reasonably believes it tends to show an actual or likely:

- Criminal offence
- Failure to comply with any legal obligation
- Miscarriage of justice
- Danger to an individual's health and safety
- Damage to the environment
- Deliberate concealment relating to any of the above

For a portfolio company terminating a manager, whistleblower protections can have broad application and may afford the manager the right to argue dismissal by reasons of the disclosure. Whistleblowers can claim for uncapped compensation without needing any qualifying service, whereas compensation is usually limited and employees must have completed two years' service to claim unfair dismissal.

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As a result, we anticipate an increased focus on establishing a clear evidential trail setting out reasons for dismissal outside of any protected disclosure. Employers should also ensure they have implemented robust processes to identify and investigate potential whistleblowing allegations (which may be buried in an employee grievance or email chain). This requires collaboration between an organisation's legal, HR, and compliance functions.

Mitigating risk by improving culture

Recent deals have, unsurprisingly, seen a greater emphasis on cultural diligence. Not only are PE firms reviewing a target's COVID-19 response, as well as its broader health and safety procedures, but they are also seeking to better understand whether the target maintains an overall healthy corporate culture. This can include reviewing a company's whistleblowing data, understanding how it handles reports, the outcomes it reaches, and how solutions are implemented.

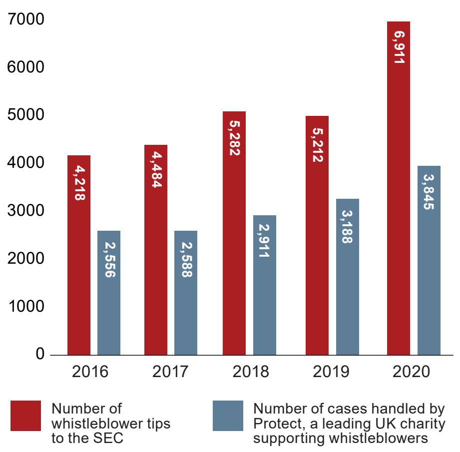
While there is no perfect company culture or way of handling allegations of misconduct, when it comes to whistleblowing, a culture of "speaking up" without retribution is crucial. From a risk management perspective, this approach helps companies to minimise employment claims and reduce the likelihood of regulatory exposure. Risk management tools (including Latham & Watkins' Culture Assessment Framework) can help buyers and targets measure and monitor an organisation's cultural trajectory, and identify and address difficulties should they arise. It can also be used to review companies' whistleblowing processes and help businesses to adopt workable solutions.

BEST PRACTICES FOR HANDLING WHISTLEBLOWER ALLEGATIONS:

- Implement a robust whistleblowing policy outlining the process by which all whistleblowing complaints should be raised and will be investigated
- Formulate a clear strategy on how any investigation into whistleblowing allegations will be handled that addresses: Who will run the investigation? Who will be interviewed? Which documents will be reviewed? How will interview questions be framed to ensure they are careful and consistent?
- Manage expectations around anonymity and confidentiality of both the whistleblower and any employees interviewed as part of the investigation
- Develop a clear strategy for any internal messaging and external reporting requirements arising from the whistleblowing allegation and investigation outcome
- Ensure anti-retaliation measures and monitoring arrangements are implemented

Maintaining a compliant environment and taking the proper precautions will reduce the odds of whistleblowing claims — saving firms time and cost, while reducing the risk of reputational damage.

An Increasing Volume of Whistleblower Tips and Cases

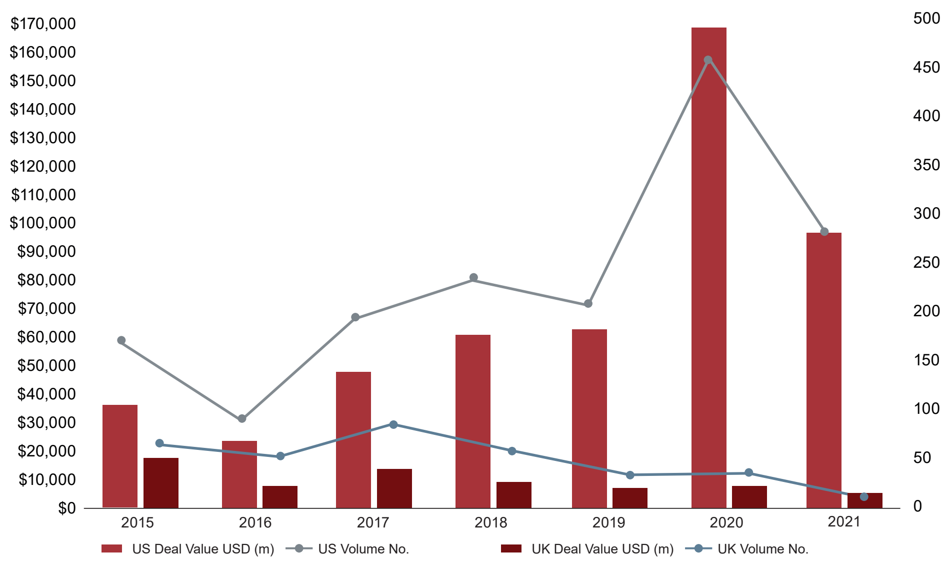


Source: US Securities and Exchange Commission Whistleblower Program 2020 Annual Report to Congress/ Protect 2020 Impact Report

Exploring IPOs with Dual Class Shares — Emerging Possibilities for PE

Listing of dual class share structures, which give certain owners (usually founders, employees, and pre-IPO investors) enhanced voting rights over other public shareholders, are increasingly common in the US markets as a strong pipeline of founder-driven tech companies goes public. The UK has now seen several dual class share structures, including most recently the £5.4 billion IPO of The Hut Group, which had a "special" share for the founder. With the UK government keen to increase the marketability of UK listings following Brexit, we anticipate that US dual class deal architecture is likely to be featured on a growing number of London listings — a development that could benefit PE firms and founder managers seeking to retain a greater governance role post-IPO.

Recent US and UK Listings – Value and Volume



Source: Dealogic

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The US Approach

US deals, such as Bain's listing of Canada Goose and the recent listings of Airbnb and Snowflake, demonstrate a pathway for investors and PE firms to take a portfolio company public, allowing founders and other pre-IPO shareholders to retain control in the listed company. While dual class share structures on US IPOs are not new, they have become increasingly marketable in the current buoyant market, and are popular with founders seeking to guard against hostile takeovers and activist shareholders.

An Evolving European Landscape

Two changes mean that PE deal makers will need to become familiar with this share architecture in the UK, notwithstanding that they are not currently permitted on premium London listings.

First, dual class share structures are already permitted on standard UK listings. While historically many companies have preferred the prestige and FTSE 100 index eligibility associated with a premium listing, this is changing. Notably, companies such as The Hut Group (London's biggest-ever tech IPO) and Sir Martin Sorrell's S4 Capital both opted for standard listings and provided for dual class share structures.

Second, dual class share structures are permitted on many European stock exchanges, including Euronext Amsterdam, and were introduced in Italy in 2020.

On 3 March 2021, the UK Listing Review led by Lord Jonathan Hill was published, making a raft of recommendations to the UK government to reform the UK's listing regime to both strengthen and increase the competitiveness of the UK's capital markets. Among the recommendations is to permit premium listed issuers to have dual class share structures for a maximum of five years following an IPO and with a maximum weighted voting ratio of 20 to 1 to provide a way for founder-led companies to evolve and grow, without being immediately vulnerable to a takeover.

As a host of tech companies line up for IPOs in the coming years, if implemented, such dual class share structures may well help lure Europe's best founder-driven businesses to the London market and ensure that Britain regains its advantage in the global markets.

The PE Opportunity

It remains to be seen whether dual class share structures, particularly those recommended in the UK Listing Review, will enable PE investors retaining a stake post-IPO to preserve controls over the company in order to guide post-IPO performance and the realisation of shareholder value, or allow pre-IPO management incentivisation structures to roll forward into the listed entity.

WHAT ARE DUAL CLASS SHARE STRUCTURES?

- Involve two (or more) different classes of shares with differential voting rights
- Founders and other pre-IPO holders are able to maintain voting control of the publicly listed company through holding shares with enhanced voting rights (often 10:1 to shares sold to the public, though this has started to vary in recent US deals)
- All other public shareholders have lesser voting rights

Key Advantages

- Founders can concentrate on the company's long-term strategy, growth, and performance without having to keep one eye on short-term targets and the risk of shareholder activism while the company is still in the high-growth phase
- Founders have control over takeover attempts and other key decisions in the company

Key Disadvantages

- Goes against the "one-share, one-vote" principle, which has long been seen as a core bedrock of investor protection in the UK
- Founders with enhanced voting rights could dominate decision-making, with little or no representation on policy or strategy for those that provided much of the company's capital, contributing to an erosion of accountability
- Conflicts could arise between entrenched founders and management and other shareholders

PE Goes Gaming

The global gaming market reached a valuation of US$135.8 billion in 2020, accounting for a staggering 53.3% of the digital media industry. Further, global video game revenue in 2020 jumped by 20% to US$179.7 billion, making the sector larger than the film and North American sports industries combined.

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PE firms have demonstrated their growing appetite for gaming deals, particularly those with successful online multiplayer titles and loyal followings. Notable recent examples include Carlyle's acquisition of Jagex (Runescape and other titles) and Synova Capital's sale of its position in Tonic Games (Fall Guys / Ultimate Knockout), both of which we advised on.

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While the gaming sector has benefitted from COVID-19 precipitated changes to consumer behaviours, the uptick in gaming adoption is not merely a temporary spike; market forecasts project 10.2% annual growth through 2025, with sales rising across consoles, mobile games, and esports. As the gaming sector continues to boom, we believe that PE buyers will see more investment opportunities.

A Maturing Market

The gaming sector has developed significantly in the last five to 10 years, attracting more institutional investors, while also remaining fragmented with smaller players developing exciting titles and ideas. Venture capital firms have enjoyed success in the video game space, which we believe is likely to generate a strong pipeline of acquisition opportunities for PE buyers. We also anticipate significant scope for PE-sponsored buy and build activity across the industry.

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Despite these developments, there is no shortage of exit opportunities for attractive gaming assets. SPACs and the public markets, particularly NASDAQ, offer viable exit routes to developers from around the world. Further, a growing number of well-capitalised developers are seeking acquisition opportunities of smaller players, with large-cap gaming companies prepared to pay high multiples for strong assets. Accordingly, PE dealmakers should expect competitive tension on attractive acquisitions.

Crafting the Best Deal in a Global Market

M&A activity in gaming is now truly global, with robust gaming industries taking root in markets ranging from Stockholm to Zagreb to Tel Aviv. However, the industry's globalisation can bring challenges for dealmakers seeking to navigate complex and conflicting rules.

Dealmakers will need to verify key IP and software ownership issues, including use of open-source software, external developer risks, and securing trademark protections and other IP rights across key jurisdictions. Compliance is also critical. The huge increase in users is a key driver of many successful games, bringing privacy and child protection regulations into focus.

While the regulatory landscape has improved as global regulators clarify their stance on sector-specific issues (such as in-game purchases), challenges remain. European competition regulators have articulated ambitions to enhance consumer protection and have targeted cross-border selling restrictions of games. Further, loot box use (game features associated with gambling that allow access to a virtual box of items for in-game use, either acquired by gameplay, or purchased) has witnessed greater enforcement particularly in Europe; notably, a leading gaming company received a €10 million fine over loot boxes last year.

Firms looking to buy into the sector should also consider that video game developers often require a significant upfront and ongoing investment, particularly on marketing spend. Games can take several years to develop, especially in the console space. However, successful games can have a lifespan lasting more than a decade (in fact over 20 years in the case of Jagex's Runescape), generating attractive returns for successive investors.

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