KEYNOTE INTERVIEW

Creative deal structuring spurs an uptick

Sponsors are thinking outside of the box to find pockets of capital and get deals over the line, say Jack Orford and Robert Smith, sponsor finance partners at Davis Polk & Wardwell

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Q What are you seeing currently in the private equity deals market, particularly with respect to technology investments?

Jack Orford: This year we have seen M&A activity gradually ramping up and we expect that to continue. Technology and software has been one of the brighter spots in the last couple of years while the market overall has been quite subdued.

Given where valuations were and where they are now, it is not surprising that the data shows that private equity exits have been at historic lows. Hold periods have been pushed out and that has obvious follow-on consequences for deal activity. It has also been a significant driver of activity in other areas – principally fund finance and secondaries – as sponsors have found alternative ways to return capital to investors or extend investment horizons.

The mid-market space has been less impacted and we continue to see reasonably strong activity there. A lot of the dealflow in leveraged buyouts has been driven by add-on transactions as opposed to new platform deals. The targets are sometimes smaller businesses with existing venture capital investors who are looking to pull up stumps. In general, smaller deals have seemed easier to get done perhaps because the cost of debt matters a bit less there.

Robert Smith: Notwithstanding the gradual increase, M&A activity continues to be supressed, especially when compared to the peak that we saw in the technology space back in 2022. That is for two main reasons: first, interest rates remain elevated versus the near-zero rates that were fuelling the dealmaking boom and, second, people are still having a hard time moving

off the record valuation multiples that were clearing the market in 2022.

Each of those challenges is loosening to a degree, though. We saw the rate cut from the US Federal Reserve in September, and the market has probably priced in some further cuts, which will make it cheaper to obtain debt financing for new deals. Buyers and sellers are also starting to rationalise the valuation bid-ask spread. Technology will always attract higher multiples because of the likelihood for growth and that is not going to change, but multiples do seem to be coming down from their peaks.

Putting it together, all of the "cautious optimism" that we have been hearing about over the past nine months now feels like it is coming to fruition, and we expect that to lead to more deal activity in 2025.

Q In this environment, how can buyers and sellers get tech deals over the line?

RS: If sellers show any kind of willingness to take seller paper, that goes a long way towards getting deals done. That can be a seller note, essentially committing to pay a portion of the purchase price at a later date, or earn-outs, which buyers tend to prefer, particularly where there is a management team involved with high conviction around the business.

With the cost of debt still elevated, sponsors have also gotten creative in finding other pockets of capital to use to finance these deals. Holdco PIK instruments have received increasing attention, as those instruments typically have no cash payment obligations, which blunts the impact of higher interest rates.

Co-investments also tend to be a big theme for a lot of our private equity clients, and that is no longer just with historic LPs in a fund. A lot of sponsors are affirmatively asking for lender co-investment now, which used to be frowned upon; if sponsors need to plug a funding hole and can get another $25 million from lenders as equity, that can be quite helpful.

So, if seller paper does not work, there are other creative financing options available from the buyer's perspective.

JO: That is another thread highlighting one of the consequences of the rise of private credit, where lenders can be more flexible and deliver highly customised credit solutions that just would not be seen in the syndicated market. While syndicated debt financing activity has been on the increase, private credit is still very competitive for buyouts at almost all transaction sizes.

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>
> **ROBERT SMITH**

In terms of getting deals over the line, there is only so much that can be done when there is a substantial valuation gap. Private market valuations in the sector continue to lag behind the public markets, which are of course heavily weighted to a small number of names.

In the larger deal space, we have seen a reasonable number of carve-outs from larger companies where certain assets are non-core and the seller has decided it is time to let them go, reduce debt and focus on other business units.

We are also starting to see more private equity assets coming to market. Some private equity firms are setting up (or already have) exit committees to look holistically across their portfolios and identify when and how best to sell, recognising that a more individualistic approach controlled by a deal team may have a natural tendency to favour holding assets a bit longer in hope of higher prices.

Q Which subsectors are especially compelling to PE investors right now?

RS: When we talk to clients in the mid-market space, AI is something that everyone is discussing but not something that anyone wants to invest in. Our mid-market private equity sponsors have portfolio solutions teams that help portfolio company management optimise value creation for the portfolio company, and those teams are all looking at ways to use AI and other technology-enabled solutions to drive efficiencies.

But the PE investment professionals do not want to commit money to purchase AI-focused companies yet and the deals in that space do not yet exist in a format that is in the private equity sweet spot.

A lot of these AI companies are still very much in start-up phase, which is more attractive to venture capital investors than most PE firms.

JO: I agree that there does seem to be substantial polarisation between early-stage companies that are more venture capital focused and then a handful of already very large players that have already attracted huge amounts of capital from the likes of Microsoft, Meta and so on. The task of picking winners is obviously not easy.

On the defensive side, I do think private equity is very focused on the potential for disruption to existing businesses. Particularly in the software space, now that there are AI products that can take a prompt and write a piece of software from scratch.

RS: Unlike AI-based companies, technology infrastructure investments are

still of real interest to PE deal teams, so assets in subsectors like cybersecurity and cloud computing have been getting a lot of looks. A lot of those businesses fit what private equity is looking for – they have stable revenue but a path to growth, with many having received some uplift from AI adoption, and they are often still founder owned and receptive to private equity capital.

Q What pitfalls should PE investors be mindful of when raising debt financing for these transactions?

RS: The first thing for sponsors to think about is whether they are looking at the debt financing as a recurring revenue-based deal or as an EBITDA-financeable deal, as the market tends to approach those differently, especially around some pretty fundamental terms like pricing and the financial covenant.

If it is a recurring revenue deal, then sponsors should also be mindful of if or when the deal might "flip" to look more like a traditional EBITDA-based deal. However, lenders have become much more flexible on this point as recurring revenue deals have matured and become recognised as a workable financing model that does not carry the risks that people were once concerned it did.

The other thing we have been hearing a lot about in debt financing transactions are these so-called "named protections" like J Crew, Pluralsight and so on that have arisen from recent well-publicised liability management exercises. Many of these protections seek to limit a portfolio company's ability to move intellectual property around within its organisational structure, so they deserve particularly careful focus in technology transactions from both borrowers and lenders.

JO: Yes, there is a lot of energy around those issues and it is very easy for a borrower to end up with a provision that, while it protects lenders from certain types of liability management transactions, actually goes much further and could restrict all sorts of things that may make sense for the company and really everyone in the capital stack – whether that be a tax-related restructuring or bona fide strategic transactions with respect to IP assets.

Whether or not the deal is EBITDA- or recurring revenue-based, the finer details of the financial definitions tend to be trickier in software deals. Revenue recognition rules under GAAP or IFRS can be complicated, and the approach to recognition may differ across various products and services offered by the same company.

Not uncommonly – where one side or the other isn't completely happy with the way that works – you will have some kind of adjustment to EBITDA. Adjustments to EBITDA for the net change in deferred revenue are common but there are other varieties as well. ■

Q What can we expect going into 2025?

JO: In the last six months, we have continued to see quite a lot of repricing activity. We are even seeing cases where incumbent lenders are showing up and offering proactively to reprice and remove the risk of a bigger process that might lead the sponsor to look for another lender. So, certainly we expect that refinancing work to get busier.

The theme to watch now is going to be how quickly rates come down and how quickly that spurs an uptick in M&A activity, but we are certainly optimistic about more deals getting done in the next 12 months.

RS: We have been seeing three big pockets of activity as we move through to the end of 2024. As interest rates remain high, companies in trouble are now looking for covenant and liquidity relief from lenders, so that is driving a fair bit of activity.

At the same time, the interest rate spreads that lenders are demanding have come down, so good companies are finding it easier to do refinancings as Jack noted. The reduction in spreads is also helping to drive the gradual uptick in M&A activity we discussed earlier as well.

As interest rates continue to come down, we expect that first category of activity to ease. The companies we are dealing with that are in trouble are challenged not because their businesses are over-leveraged but just because the cost of capital has gone up and they are having a hard time servicing that. So, those liquidity issues can easily be relieved by lower interest rates in 2025. Piggybacking on Jack's comments, I agree that lower rates will also allow and encourage more refinancings and more M&A deal activity.