Hughes Hubbard & Reed

M&A, PE and VC Transactions in a High Interest Rate Environment

Client Advisories

Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

Attorney advertising. Readers are advised that prior results do not guarantee a similar outcome. No aspect of this advertisement has been approved by the Supreme Court of New Jersey. For information regarding the selection process of awards, please visit https://www.hugheshubbard.com/legal-notices-methodologies.

In 2022, for the first time in 15 years, the Federal Reserve rapidly raised the federal funds rate in response to an increase in the rate of inflation not seen in four decades. The federal funds rate is a range of interest rates that lending banks charge other banks to borrow overnight excess capital reserves held by the lending bank at the Federal Reserve in order to maintain the borrowing bank's minimum capital requirements. The effective federal funds rate increased from 0.08% in January 2022 to 4.58% in February 2023. It is forecasted to reach around 5.5% before the end of 2023. The higher federal funds rate increased the capital costs of banks and, as a result, increased the market interest rates that banks and other lenders charge their customers. The increased interest rates continue to adversely affect commercial transactions, including mergers and acquisitions, private equity, and venture capital transactions, causing parties to focus on terms in such transactions that have not been relevant over the last 15 years.

Executive Summary

- Increased interest rates will affect the cost of borrowing used to finance many transactions, as well as the opportunity costs of making deferred payments such as earn-outs, escrows and holdbacks, and sellers may demand interest on such payments.
- Sellers may prefer to use a "locked-box" model to determine the final purchase price of a target instead of the more commonly used post-closing purchase price adjustment.
- As a result of increasing interest rates, the high-yield bond market was shut for many issuers for most of 2022, and in turn, the viability of bank-financed bridge loans for private equity deals was adversely affected. For deals to continue, private equity financing structures have shifted and adapted.
- Venture capital investors may move away from so-called "SAFEs" and return to interest-bearing convertible promissory notes.

Increase in Financing Costs

- Many transactions, especially those in which financial sponsors are buyers, are dependent on using leverage to finance a meaningful portion of the purchase price.
- The increase in interest rates will increase the cost of borrowing and conversely decrease returns to equity investors.
- Some borrowers with existing (variable rate) loans may not be able to service their debt.

Deferred Payments

- To mitigate risk, buyers often seek to structure M&A transactions so that a portion of the purchase price is paid to sellers post-closing (including post-closing earn-outs, escrows or holdbacks for potential indemnification claims or post-closing purchase price adjustments).
- Sellers view deferred payments as an accommodation to buyers: After all, a deferred payment is consideration that would otherwise have been paid at closing.
- During the last 15 years, it was rare for interest to be charged on deferred payments. But in the new environment, sellers will not want to lose out on the enhanced time value of money and will expect to receive accrued interest on deferred payments when they are eventually paid.

Escrows

- Buyers often hold back portions of the purchase price (particularly amounts to secure any purchase price adjustments or buyer indemnification claims) in escrow accounts to be distributed at an agreed-upon time (or times) post-closing.
- Escrow agents charge fees for their escrow services and earn money from these escrow fees as well as interest from investing or lending the escrowed funds.
- In the current interest environment buyers and sellers may insist on earning interest on escrowed funds.
- Buyers and sellers will also need to negotiate the split of the accrued interest amongst themselves (and related tax provisions) if the escrowed funds are not used entirely to satisfy buyer claims. Such terms have been largely ignored while interest rates were low.

Post-Closing Adjustment

- In a typical post-closing purchase price adjustment, the closing payment paid to sellers is based on an estimate of the target company's financial affairs at closing. A few months after the closing, buyers and sellers determine the target company's actual financial affairs as of the closing date.
- The parties settle any differences between the estimated closing payment and the final purchase price through an adjustment payment.
- Parties may now expect to receive interest on the adjustment payment, if any, paid to them several months after the closing.

Locked-Box

- In the locked-box model, which has gained popularity in Europe but less so in the United States, the parties lock the purchase price of the target company ahead of closing, based upon certain agreed-upon historical financial statements of the target, often its most recent audited year-end financial statements. There is no adjustment of the purchase price at or following the closing.
- Buyers realize the benefits of any increase in the target company's value after the lock date, without having to pay any additional purchase price.
- As an offset of buyers' potential upside, buyers pay sellers interest on the locked purchase price from and after the lock date until the closing of the transaction.
- Sellers will expect to be paid higher interest rates, to correspond to the increased interest rates that they could have earned from investing the purchase price at the lock date.
- In a locked box deal, sellers are subject to tight operating covenants and restrictions around value extraction between signing and closing before buyers take control at closing.
- Despite these restrictions, in times of market turmoil, sellers may still find the locked box more attractive than the post-closing purchase price adjustment. This is because, in addition to the accruing interest:
  - The purchase price is protected from decreases in value caused by adverse market conditions.
  - There is no time delay in determining the final purchase price, which, in a post-closing adjustment model, is dependent on buyers' completion of calculations.

    - There is also no risk to sellers that they may need to repay money if the buyer's calculation of the final purchase price is lower than the closing payment, and no need to hold back or set aside a portion of the purchase price for the eventual final purchase price adjustment calculation and true up (especially customary where sellers are not creditworthy/continuing businesses).
    - The interest buyers must pay on the locked purchase price amount acts as a ticking fee to incentivize buyers to expedite closing the transaction.
- A buyer may take the opposite view in times of market turmoil.
    - Although a buyer receives the benefit of value increases between the lock date and the closing date, it also suffers the risk of a decline in value, which becomes more likely in a downturn.
    - In addition, the locked-in higher rate of interest may deter buyers from agreeing to a locked box deal where a significant interim period (between signing and closing) is expected.

Private Equity Deal Terms

- Acquisitions by PE funds are typically funded at closing through short-term bridge loans from banks and refinanced shortly after that through the issuance of (high-yield) bonds.
- For most of 2022, increased interest rates shut the high-yield bond market for some issuers, and as a result, banks have become far less willing to make bridge loans to private equity without a high-yield bond market to refinance these loans.
- In order to continue making investments, private equity must look for alternative financing methods, which include writing larger equity checks or tapping private credit funds. However:
    - Larger equity checks reduce the debt-to-equity ratio PE funds typically strive for in acquisition transactions, which can lessen the potential upside of an investment for fund investors.
    - Loans from credit funds and other private lenders are sometimes more expensive than loans from banks. In an environment with increased interest rates, paying a further premium over the cost of bank financing may have further adverse effects on PE deals.

Venture Capital Investment Structure

- Over the last decade, venture capital investors have largely replaced the traditional convertible promissory note with a 'Simple Agreement for Future Equity' (SAFE).
- SAFE agreements have similar features to convertible promissory notes, including, most importantly, the mechanism for investors to convert their capital into equity in the start-up.
- However, SAFE agreements lack certain "debt-like" features of convertible promissory notes. In particular, they do not provide for accruing interest or a maturity date with the intent that these investments could continue in perpetuity, without interest, and without the obligation for the Company to repay them as loans, until an eventual new equity financing is consummated or another trigger event occurs.
- In a challenging economy, a convertible note has the additional benefit of being a debt instrument prior to conversion, and hence senior to any equity instrument (whereas SAFEs are often treated as equity instruments as they lack an obligation to repay at maturity).
- As rising interest rates may lessen the potential upside of seed capital investments, to continue to invest, investors will push to receive interest on their investment. This may lead to a resurgence of convertible promissory note financings in early stage start-ups.

Related People

Gerold Niggemann

Michael Traube

Valerie Ben-Or

Related Areas of Focus

Corporate
Corporate Governance