The Five Tools of Private Equity – Part Three: Execution

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Closing seems easy until the deal falls apart.

So far in the Five Tools of Private Equity series, we have reviewed the "sourcing" tool (how firms generate investment opportunities) and the "evaluation" tool (how firms determine the return profile of a prospective investment). By this point in a deal's life cycle, a potential investment has been identified and evaluated, and the investor is ready to propose the outline of a deal.

On its surface, this part of the investment process appears simple. If the investor has evaluated a business and concluded that it is attractive to own at a certain price and structure, and the seller is amenable to that price and structure, then how hard could it be to just sign some legal documents? Unfortunately, every investor has a "broken deal" story: a deal that fell apart, often at the last minute, costing the investor time and money. In some circumstances, the investor's skill and experience can help to minimize the likelihood that this happens.

The investor's **transaction execution** tool is what it uses to successfully convert a proposed deal into a closed deal. This process encompasses a range of abilities—communicating offer terms, completing due diligence, and occasionally acting as an amateur psychologist. In this installment, we'll look in-depth at what happens between proposal and closing (and what can go wrong).

Transaction Execution: Completing the Proposed Investment

Before getting into "execution mode," the buyer and seller have to come to an agreement on an outline for a deal. The process of getting from agreement to closing is collaborative, and takes a meaningful investment of time from both parties, neither of whom want to find out later on that they were talking past each other all along. Getting aligned on the major components of a deal usually involves putting them down on paper.

The Acronym Salad of Proposal Structures

There are lots of names for documents that serve the purpose of turning a deal into written form. IOI, LOI, term sheet, PA, PSA, SPA, APA ... some of these are well-defined documents, others are looser concepts, and if that wasn't confusing enough, several of these are used interchangeably.

Early in the deal, an Indication of Interest ("IOI") might be the first written offer the buyer gives the seller. At this point, the buyer has probably had little access to confidential information—high-level financial statements, an operations overview, maybe a conversation with management or a representative (like an investment banker or broker).

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Accordingly, an IOI is filled with caveats. An IOI essentially says "assuming the business is as described at a high level, here is how we would look at price and structure for an investment, and here's some more information about us that should lead you to believe we are a credible buyer." It's not uncommon to communicate a range of prices instead of a single price in an IOI, to reflect the level of uncertainty involved.

A Letter of Intent ("LOI") is not that different than an IOI, but for the degree of certainty involved. An LOI usually comes a little bit later in the process, after the buyer has had time to investigate and digest a much larger selection of information about the business and its operations. An LOI is a much firmer proposal than an IOI, and can be thought of as an actual "deal outline." An LOI would describe price, structure, expected areas of due diligence (more on this later), time to close, sources of financing, and any other specific deal terms important to get out on the table.

An LOI also usually proposes a defined exclusivity period, which is likely the only legally binding section of an LOI. A legal team should be able to look at an LOI and use it as the basis for drafting the actual legal documents describing the transaction; they wouldn't be able to do that with an IOI.

A term sheet serves a similar purpose as an LOI and would appear at roughly the same stage in the process, but the difference is that a term sheet is an LOI without the fluff.

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A term sheet looks more like a schedule or a table, while an LOI looks like a letter. A term sheet can be distilled from an LOI, and an LOI can be built from a term sheet, but both are ways to communicate specific deal elements and provisions.

Each of these documents—an IOI, an LOI, and/or a term sheet—is used to summarize a prospective transaction and often opens a period of negotiation. It takes time and legal expertise to draft a purchase agreement, so it's useful to have a summary to agree upon beforehand.

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Therin lies the rub, though, as any summary can be oversimplified, and these summary documents aren't binding. If one party changes the deal between this stage and final agreement, or even if a party is perceived to have changed the deal, the resulting fallout can wipe out goodwill created by working together and put the deal at risk. Good transaction managers (on both sides of the table) make sure to include pertinent information and deal terms out on the table early and clearly, minimizing the risk of surprises later.

The alphabet of purchase agreement ("PA") terminology comes next. Purchase agreements are the signable legal documents detailing every facet of the transaction and are the agreements of record. A purchase and sale agreement ("PSA") is synonymous to a PA; various forms of a PA, like a stock purchase agreement ("SPA"), asset purchase agreement ("APA,") and other varieties of purchase agreement are specific to the interests being exchanged and are not technically interchangeable (although they often are used interchangeably).

Regardless of the document and its form, the best practice for an investor is to clearly communicate a position as of a point in time. The biggest disconnects between buyers and sellers come from different perceptions of certainty that a deal will be closed in alignment with the economics as described. Some investors try to exploit reasonable deniability to their advantage, as anyone who has experienced an eleventh-hour "re-trade" can confirm. But by and large, most investors are honest, if not excellent communicators, and a strong execution function will clearly communicate a buyer's position (for better or worse) at all points along the execution timeline. Since not everyone adheres to common definitions for documents, focusing on the content of what's delivered, rather than what the document is called, is a better recipe for successful execution.

The Due Diligence Grind

Once an LOI or a term sheet has been signed, the parties to the deal have agreed to work together toward a closing. Closing is always subject to "confirmatory due diligence," which means wildly different things to different people, and is almost always a source of miscommunication and frustration.

The whole purpose of due diligence is supposed to be to confirm what is already believed. For instance, a buyer might believe that a potential investment has no environmental liability due to spills or accidents on its property, and the buyer would then undertake an environmental study to confirm. In a more complicated scenario, a buyer might believe (because

the seller explained this previously) that the seller is currently engaged in a lawsuit that represents an existential threat to the continuation of the business; in that case, the buyer would want to intimately examine the lawsuit to make an independent judgment of the size and likelihood of exposure, ultimately determining whether to complete the investment, make an adjustment to its offer, or back away entirely.

This method of hypothesis-based, targeted due diligence is the gold standard of transaction execution, as it saves time, cost, and quickly focuses any further negotiations on items that truly move the needle. Unfortunately, it's hard, and requires that a buyer knows what it's looking at and what questions to ask, and that a seller has accurately and fairly disclosed important information about the business. Often, one of those is not true, and due diligence becomes a slog, an expensive and expansive game of "let's see what you're hiding from me."

It is all too common that a modern private equity firm delegates the execution of this fact-finding mission to a vice president or director-level employee, a "quarterback" who manages the workstreams of a broad team of outsourced specialists who independently pursue their areas of interest in a tight timeframe.

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What results is multiple teams requesting thousands of pages of documents in order to generate detailed reports (lengthy, to justify their authors' inclusion in the process) that ultimately sit on a shelf, disconnected from any kind of feedback loop that would alter the framework of a deal.

Turning over rocks for the sake of turning over rocks is a mark of an execution process lost to its own machinations, and ultimately a risk to the completion of a deal. [You may recognize this argument echoing the one made in Due Diligence: Investigate What Matters, by Mark Working in the Summer 2018 issue of Insight].

More than derailing the focus of a transaction, due diligence gone awry can have a catastrophic impact on the outcome of a deal. Tensions naturally get higher as the deal approaches a conclusion; the deal teams are tired and stressed and nervous about imperfect information, all of which serves as accelerant for perceived slights or miscommunications to ignite. For all the planning and strategy that goes into executing a transaction, sometimes the most valuable quality to have is a cool head.

Amateur Psychology Abounds

Many experienced transaction professionals will joke that more than a third of their job is psychology. People are naturally emotional creatures, and the effects of those emotions magnify within range of major life events, like the sale of all or part of a business.

Much of the execution tool is the ability to minimize the size and frequency of speed bumps along the process. But no deal is ever free of any speed bumps at all, so the

other side of the coin is the ability to minimize the reaction and fallout when speed bumps come along.

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Miscommunication is at the core of most transaction disruptions—not bad-faith actions—but the stakes are high enough that the default assumption of most people is to believe that someone is trying to trick them.

Cooler heads prevail in much of life, and especially so in deal execution. Identifying miscommunications as they're happening, putting concepts clearly in writing, capturing details, resisting the urge to gloss over complexities, and most of all taking deep breaths and exerting a calming influence on your immediate surroundings are all hallmarks of deal professionals with execution proficiency.

Execution in Relation to Other Tools

Since this article is being written from the cozy confines of a boutique investment banking firm, you would be fair in assuming that the conclusion is that execution, of all the private equity tools, is by far and away the most valuable. Of course the inclusion of an experienced dealmaker on your team is of paramount importance, the alternative being a certain trip into the depths of the Broken Deal Abyss of Despair. (It's just off I-95, south of Newark.)

It isn't, though. If execution experience was a necessary component of successful investing, then a review of successful investments would exclusively feature investors with execution experience. Instead, you'll find that it looks much more like the finish line of a marathon: all shapes and sizes.

Having capability in transaction execution does have value, or else private equity firms wouldn't hire loads of investment banking analysts every year to fill their junior ranks. But it can't make up for deficiencies in other arenas, and it isn't the core competency on which the investor derives a market-beating ability to generate returns. Because of that, it can be (and often is) an element of the investor's toolkit that can be outsourced.

We're past the halfway point, having now reviewed the sourcing, evaluation, and transaction execution tools. Next up in the Five Tools of Private Equity series, we will look at the tool that business leaders will have the most to say about: portfolio management.

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