ALTERNATIVES WATCH

Schulte Roth & Zabel expands services as private market deal flow hits historic levels

Posted on November 15, 2021 by Susan Barreto

Michael Flynn

Long-time private capital lawyer Michael Flynn has seen a pattern in his work with growth capital investment that boils down to more deals closing at a blink of an eye compared to where they were a decade ago.

Flynn in the last month joined alternative investment specialist law firm Schulte Roth & Zabel (SRZ) in the firm's New York office to help private market investors put money to work at a time where analysts suspect there are trillions in dry powder hunting for opportunities.

Over the last 18 months or so the growth capital and venture capital investments segment of the market has exploded, Flynn said in a recent Alternatives Watch interview.

"About that time, I noticed that it wasn't an isolated shift. It soon became clear that the team at SRZ and I share an understanding that this is where the industry is going," Flynn remarked.

Over the last 27 years, much of his work has been with dedicated venture capital and private equity funds, but beginning a few years ago he saw an increasing trend in participation from hedge funds and family offices. It's this shift in client appetite that SRZ anticipated and responded to, according to Flynn.

Industry analysts say that the deployment of dry powder has remained a challenge in the private equity industry over the past year. According to a recent analysis from JP Morgan, 2021 deal activity through the third quarter is making new records in the U.S. and Europe with sectors such as technology and software leading the way. The total deal value of U.S. private equity transactions in 2021 through the third quarter at nearly $790 billion is already exceeding the previous high of around $750 billion in 2019.

These figures confirm the trends Flynn is seeing on the frontlines. He finds that the last 18 to 24 months have been particularly brisk and there are a nweumber of successful companies looking to do IPOs and this is likely in Flynn's estimation what is driving traditional hedge funds into illiquid private equity investments.

Now that the path to going public is a matter of waiting three to six quarters rather than years, the ability to exit these transactions quickly has broken down any internal resistance on the part of hedge fund portfolio managers in getting involved in these less liquid investments.

A mid-stage, Series C round company needs to demonstrate a jump in valuation and so often, in Flynn's experience, a growth equity round that may include heavy participation from hedge funds really helps.

"Ten years ago, if you had cash on your balance sheet, it was an impediment to raising capital," Flynn said. "In the last three to five years that seems to have lost its stigma. Now, you can raise a growth capital round and then promptly go public."

For Flynn, the timetables of the transactions have quickened as well. In an ordinary year, he used to complete 20 to 30 investor transactions. Now he said he has done 20 in the last quarter.

Much of the activity has been in life sciences, but activity also remains strong in the fintech, consumer and alternative energy sectors, among others.

"We are seeing an incredible compression in time frame: receive the paperwork Monday, sign Thursday, and wire Friday," Flynn said. "A few years ago, representing a member of a syndicate would mean four weeks to seal a deal, now two weeks seems like a long time."

The feeding frenzy however is not without risks, particularly to hedge funds that are relatively new investors in the space and are often looking to staff up with in-house private equity expertise. In Flynn's view though it is only a matter of time when the level of deal volume drops and the complexity of what managers need to handle goes up exponentially.

There are three key challenges hedge funds face when the tide turns. First off, the move from a short-term position to a long-term position and managing that illiquidity. Secondly, monitoring of these illiquid investments. Firms that have staff in place with experience in monitoring boards of directors and handling these types of scenarios will come out on top, Flynn said.

Lastly, there is an issue of general alignment when late-stage high valuation investors have to contend with earlier stage investors at much lower price points. Flynn uses the example of three rounds of company fund raising with 10 million shares in each round. The Series A round was raised at $1 per share, Series B round at $3 per share and then a Series C at $10 per share in anticipation of an IPO.

So if the company misses its IPO, investors lose confidence and the company needs to figure out what to do. They could raise capital and wait for the IPO market to open up. They could find a buyer out there for $5 per share, but for Series C investors they are losing out while it would be a huge win for Series A and a decent outcome for Series B, who together outvote the Series C.

In the documents though, the Series C can protect for that scenario by providing that a company can't be sold unless the Series C gets a specified amount.

It is possible, Flynn said, that as an investor you will not be protected due to a loophole in the legal provisions, as this can be a common mistake. What that means is that there will be negotiated outcomes. There will be a need to have rough adjustments to what they can salvage in the portfolio.

"Most hedge fund clients may have legal staff, but these subtle errors may be difficult to source," Flynn added. He recommends hedge funds recruit those that have venture capital experience when it comes to reviewing complex deal documentation.

"Investing in human assets and experience is a critical component to client protection," he advised. Also, there is something to be said in taking the extra time, even if it is only a few days, to review deal documents in order to gain insight on potential pitfalls in the legal terms.

For now, Flynn and his team are watching the trends closely and working diligently to keep on top of all the deal flow.

"Over the past year, SRZ has deepened its practice to enhance how it meets these emerging client interests, and will continue to do so," he said. "We are listening to the appetite of our clients and based on what we are hearing, there is unquestionably room for growth."