A ROUNDTABLE DISCUSSION

NAVIGATING THE POST-PANDEMIC PRIVATE EQUITY LANDSCAPE

Private-equity firms face intense competition for deals in today's business environment, but that's not all that's keeping them on their toes. They must also stay on top of new initiatives, such as President Joe Biden's infrastructure spending bill, proposed tax changes in the Build Back Better framework, and the challenges of taking companies public in an environment where it is not easy to accurately assess the effects of the pandemic.

For insight into the complex issues the industry faces, **Crain's Content Studio** spoke with Jeffrey Kranzel, CPA, a managing director in the New York office of the business advisory firm Riveron; Allison Sherrier, a corporate associate in the New York office of the law firm Goulston & Storrs; and Morris DeFeo Jr., a partner and chair of the corporate department at the law firm Herrick, Feinstein LLP.

CRAIN'S: How has Covid affected private-equity firms' investment and liquidity objectives?

JEFFREY KRANZEL: In some cases, liquidity objectives have had to be reset and potential sales processes delayed, as portfolio companies in specific industries have had to work through a number of extraordinary impacts negatively affecting performance such as depressed foot traffic, higher costs for property plant and equipment (PPE), labor shortages, supply chain constraints, or rising energy costs. That said, many PE firms and portfolio companies now face unique buying opportunities and can make acquisitions at attractive pricing, given that deal pricing was more inflated prior to the pandemic.

ALLISON SHERRIER: Private-equity firms leverage their portfolio companies with fairly high levels of debt, which means they always expect a certain level of liquidity risk. These firms typically assess the liquidity risk when investing. Before the pandemic, however, they were not accounting for the increased liquidity risks and challenges in their ability to make interest payments and avoid defaults that ultimately came with the pandemic's economic slowdown and customers' inability to make payments. Undoubtedly, private-equity firms are now taking potential future pandemics, endemics, and similar disruptions into account. This will likely result in more conservative cash-flow forecasting as part of their risk assessments.

MORRIS DEFEO: Covid has caused a lot of disruption in every component of the global economy, but it has also created opportunities for private-equity firms that have the resources and disposition to be nimble. The shift to remote working and greater reliance on tech and an accelerated focus on health care will likely continue to shift investment focus and perhaps cause a reassessment of traditional sectors that may experience slower growth. An example is the transition by many PE firms to longer-term investment strategies and in some cases a more measured approach to making investments.

CRAIN'S: We hear about lots of dry powder and a reduced supply of "quality" deals. Is the short supply caused by underperforming targets, businesses that did not effectively prepare for sale or some other reason?

SHERRIER: While some target businesses certainly suffered as a result of the pandemic and, therefore, were underperforming, the main driver of the short supply is the intense competition for the most desirable targets. Simply speaking, the large amount of uninvested capital, or dry powder, held by private-equity investors is creating a lot of competition in the market, and the most desirable targets can get a premium price for their business. If private-equity investors do not want to pay a premium, then they are left with less desirable targets. This was already true before the pandemic, however. The underperformance of certain businesses in the past 18 months has exacerbated the situation by decreasing the number of high-quality targets.

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KRANZEL: The short supply of quality deals is a result of a combination of factors. Businesses have rushed to put themselves up for sale to get ahead of the proposed capital gains legislation that would take eff e ct in 2022—resulting in cases where buyers are dealing with

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targets that haven't been properly prepared for a sale process. A lack of preparedness requires additional diligence and, sometmes, prediligence to get the target's financials and other data into a format that is ready for due diligence.

In addition, some sectors have underperformed because of the continued effects of the pandemic, the acute labor shortage, rising energy costs, and the supply chain disruptions affecting a range of industries, and some companies have fared better than others by getting ahead of the curve and managing through the uncertainty.

DEFEO: The market for quality deals has been tightening for some time. The enormous amount of available funding has resulted in more resources chasing fewer deals. The emergence and explosive growth of special-purpose acquisition companies has made the mergers-and- acquisitions market even more competitive. Higher valuations have encouraged a growing number of sellers to join in. Just because there are more potential buyers, however, doesn't mean there are more quality sellers. Current conditions may actually put less attractive companies into play.

CRAIN'S: What terms do you see being negotiated that were not negotiated as much before the pandemic?

KRANZEL: PE firms are paying close attention to the impact of Covid on targets' performance, and most deals consider unique or nonrecurring Covid impacts. Some items are straightforward, such as the impact of Paycheck Protection Program loans, purchases of PPE or related office improvements, and Covid-related furloughs and redundancies. Other items are more nuanced, such as determining the near-term impact of labor and supply chain disruptions in setting net working capital targets. In addition, reps and warranties insurance has become a fairly standard requirement on most deals within the past year.

SHERRIER: In the past 18 months, several areas have seen increased scrutiny in negotiations that account for the effects of the pandemic, including remote working, government mandates, and other challenges. Specifically, there are changes to the definition of "material adverse effect" and the representations and covenants targets are willing to make about the absence of material changes to their business. In addition, PPP loans and the Cares Act have created entirely new issues to be negotiated and dealt with in transactions. Among the most contentious of these is the treatment of PPP loans that are pending forgiveness and, often, the need to set up an escrow to cover the amount of the PPP loan in case it is not forgiven.

DEFEO: We have seen—and on behalf of our buy-side clients have urged—greater emphasis on legal and other diligence, including sensitivity to supply chain issues and stability of the work force. Current conditions have also affected how both buyers and sellers approach and negotiate the definition of "material adverse effect," materiality qualifiers and closing conditions, and led to a greater focus on deferred consideration structures. More buyers have now taken a two-stage approach by first making an investment with options and then using other mechanisms to acquire the remaining equity in a target.

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CRAIN'S: How has the pandemic been factored into deal pricing and payment?

KRANZEL: Definitions have been revised in sales and purchase agreements to include adjustments for any atypical fluctuations related to the pandemic, both in determining earnings before interest, taxes, depreciation and amortization (EBITDA) for setting the purchase price and determining earnouts due to sellers. In addition, net working capital definitions also specifically identify and exclude the impact of Covid on short-term assets and liabilities such as inflated or depressed inventory levels, supplier deposits, new tax liabilities, and outstanding debt related to CARES Act provisions.

DEFEO: We have seen a greater emphasis on earn-outs, longer earn-out durations and tighter performance metrics. Buyers and sellers are factoring in the effects of Covid and such considerations as the impact of government funding in doing period-over-period comparisons that affect both valuation adjustments and earn-out calculations. Moreover, the lingering uncertainty of Covid has also affected both pricing and payment terms.

CRAIN'S: Once the global economy emerges from Covid, will PE firms change their investment strategies?

KRANZEL: PE firms will likely look to broaden their investment strategy to leverage prevailing legislation (such as the Build Back Better bill) and market trends (such as the shift toward renewables and carbon footprint reduction). As a result, distressed investments will come into focus as PE firms look for value creation opportunities, including out-of-favor sectors and targets with strong underlying fundamentals that the pandemic has adversely affected. Infrastructure investments (both direct and targets that play a supporting role) will come into focus as governments across the globe look to invest heavily in this area to jump-start economic growth.

DEFEO: While many aspects of doing business will revert in large part to their pre-Covid days, Covid will certainly result in long-term or permanent changes to everything, including how businesses operate and are financed. Covid has been both a cause and a catalyst for changes in the global economy. These changes have in turn affected investing. Firms will no doubt review their portfolios to assess whether the sectors in which they are concentrating their investments need to be rebalanced to account for the likely long-term effects of Covid and the opportunities presented.

CRAIN'S: With 2022 an election year and current legislative initiatives on infrastructure and other spending on the table, how will PE firms adjust to seize opportunities and sidestep risk?

KRANZEL: PE firms will see the proposed legislation as a huge opportunity for significant cash-flow returns by supporting the various components of the proposed bill that is being considered. Public-private partnerships will largely be the realm of the largest, infrastructure-focused players willing to take on bigger and unique bets. There will be plenty of opportunities for smaller players, however, to invest in targets providing infrastructure-related products and ancillary services, such as engineering services, building materials, and more. The nature of each deal may require holding periods to be adjusted, with smaller infrastructure deal hold periods often less than five years compared to the five to seven years that is a typical hold period for PE firms.

CRAIN'S: How will proposed changes to U.S. taxes affect PE firms?

KRANZEL: The Build Back Better framework threatens to impose several key tax reforms. The latest framework now excludes many proposed changes to corporate tax and capital gains rates and certain pass-through deductions that had been the focus of conversations within private-equity markets, but the framework still includes many provisions targeting large corporations, high-income taxpayers and foreign-based entities. Most notably, a proposed corporate profits minimum tax would impose a 15% alternative minimum tax on the adjusted financial statement income (AFSI) of corporations with a three-year average AFSI exceeding $1 billion. An important observation: It *does*.

DEFEO: There are tax changes in the Build Back Better Act that could have a significant impact on private-equity firms. Among these are changes to the carried interest rules and the business interest deduction limitation.

CRAIN'S: What issues are slowing private equity in taking assets public?

KRANZEL: The effort required for a private company to become public can elongate the initial public offering timeline. Challenges include accelerating financial close and reporting timelines and hiring key personnel, such as a chief financial officer with public-company experience, a director of Securities and Exchange Commission reporting, or a new head of financial planning and analysis. Filling these roles can take significant time, especially in today's highly disrupted labor market.

DEFEO: The process of going public remains formidable. The scope and magnitude of required disclosures, the review process by the SEC, and the necessary diligence to effect a public offering all take considerable time and resources. This is why the SPAC avenue to going public has been so attractive. In addition, the issues caused by Covid are creating significant uncertainty as to valuations and projected financial performance.

CRAIN'S: What are the biggest challenges middle-market companies have had in preparing for initial public offerings?

SHERRIER: Middle-market companies face an uphill battle to successfully complete an initial public offering. Chief among these is the sheer cost and effort of setting up the business to ensure it complies with, and will continuously comply with, the stringent regulations and reporting obligations required by the SEC. Going public requires companies to invest a large amount of time and money upfront, and a company must be financially ready to weather this initial cost and a potential downturn if the IPO is not immediately successful. Because of this, many middle-market companies may prefer to stay private, and the robust private-equity market and large amount of dry powder available make this a viable and attractive alternative to going public.

KRANZEL: Most of the biggest challenges center on the theme of maturing the finance function so that the company is ready to operate as a public company. There are several big challenges companies face when preparing to become public, and often these include building out the financial planning and analysis function, implementing an enterprise resource management system, accelerating the financial close process, or preparing a internal controls program that is compliant with the Sarbanes-Oxley Act.

DEFEO: Many middle-market companies underestimate the impact, required resources, time and costs of going and being public. Infrastructure, internal controls, accounting and legal capabilities, management resources and bandwidth all need to be considered carefully before a company commits to go public. In addition, certain structural or other issues that may have occupied a lower priority may become elevated as the company goes through the rigorous diligence and SEC process. Moreover, the need to identify and attract qualified board members, particularly those meeting independence standards, can take considerable time.

CRAIN'S: What are the biggest challenges for newly public companies in the current environment?

SHERRIER: Arguably, the biggest challenge for newly public companies is being able to present accurate disclosures to their investors regarding the effect of the pandemic on their business and what they anticipate the business will look like going forward. With so much uncertainty, this is a challenge for all public companies, but the issue is multiplied for new companies with limited track records. Beyond the difficulty of describing and predicting the effects of the pandemic, the SEC has made it clear that it expects companies to provide their investors with robust disclosures and public companies to be as transparent as possible in all investor communications.

DEFEO: It can be daunting to transition from being a private, often closely held, company with limited legal and regulatory burdens to a public company compelled to address continuing SEC reporting, enhanced internal and disclosure control requirements, required financial statements, more stringent audits, and the transparency required by SEC rules and demanded by investors. In addition, adjusting to investor expectations relating to the magnitude and timing of growth and liquidity can be very difficult for management and may compel significant changes in operational, growth and financial strategies.

KRANZEL: Continuing to build out the finance organization and remediate material weaknesses in internal control are big challenges. Companies oftentimes become public before fully implementing their IPO readiness plans and continuing to implement those plans can be very challenging with the rigors of operating as a public company.

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ABOUT THE PANELISTS

MORRIS F. DEFEO, JR. is a partner and chair of Herrick's Corporate Department. He specializes in U.S. and cross-border offerings of equity and debt securities and other capital market transactions, all aspects of private equity and venture capital fund transactions, offerings and investments, corporate finance, M&A transactions and corporate governance and compliance counseling. His clients include public and private companies, private equity, venture capital and hedge funds, REITs and other business entities.

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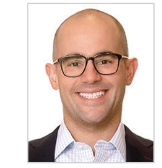

JEFFREY KRANZEL brings a wealth of industry and public accounting experience advising financial services clients on new accounting standard implementations, GAAP conversions, deal structuring, and other transaction accounting matters. He is a subject matter resource on accounting change and technical accounting issues related to revenue recognition, leasing, consolidation, financial instruments, transfers of financial assets, and more. Prior to joining Riveron, Jeff was the head of accounting policy for Mizuho Americas and director in KPMG's Accounting Advisory practice in New York.

RIVERON

ALLISON SHERRIER is a corporate attorney at Goulston & Storrs. She represents public and private companies in business unit divestitures, acquisitions, and corporate restructuring transactions. Additionally, Allison has significant experience advising clients regarding the formation of private equity funds and on general corporate governance matters.

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