akerman

2018 in Review
and Observations
for 2019

PitchBook

Opportunity
Zones

PErspectives
on U.S. Middle Market Private Equity

Volume II Edition I

Contents

akerman

Akerman LLP is a top 100 U.S. law firm recognized by *Financial Times* as among the most forward thinking firms in the industry. Its more than 700 lawyers and business professionals collaborate with the world's most successful enterprises and entrepreneurs to navigate change, seize opportunities, and overcome barriers to innovation and growth. Akerman is known for its results in middle market M&A and complex disputes, and for helping clients achieve their most important business objectives in the financial services, real estate, and other dynamic sectors across the United States and Latin America.

The Akerman Corporate Practice Group advises public and private companies, including private equity funds, on M&A, capital markets, financings, and other transactional matters, with a strong focus on the middle market. Akerman is top-ranked nationally for mergers, acquisitions and buyouts: middle market by *The Legal 500* and is recognized as a leading U.S. law firm by *U.S. News - Best Lawyers* for corporate, M&A, private equity, securities/capital markets, securities regulation, and banking and finance law, and is listed in PitchBook league tables as among the most active law firms in the United States for M&A deals.

PErspectives Editors/Producers: Carl Roston, Julia Seider-Browne, Palash Pandya, and Paul Quinn.

2018 in Review and Observations for 2019

As private markets are highly correlated with macroeconomic conditions, which are in turn significantly impacted by political considerations, it is a safe bet to assume that the buyout market will ebb and flow with the economy. The durability of an aging and historically-long economic expansion, a potential reversion to the mean of interest rates, uncertainty in Washington as to trade, economic and tax policy in advance of the 2020 elections, increasing sovereign debt, geopolitical tensions will all continue to weigh on the U.S. buyout middle market. The impact of these factors largely will be determinative of whether the slowdown in transaction activity for U.S. sub-$1B buyout funds, and in exit activity throughout the U.S. buyout middle market, during the second half of 2018 are indicators of things to come or anomalies. Political rapprochement, business-friendly public policy, good fortune with respect to geopolitical events, and a deft touch by the Federal Reserve, can only improve the buyout landscape and assuage the recently expressed macroeconomic and market concerns of respected market pundits like Bridgewater founder Ray Dalio.

Despite a slowdown in fundraising during 2018, the number of fund offerings remains robust, as Hamilton Lane reports it expected to receive a record number of PPMs in 2018. While many LPs express concern about the amount of dry powder chasing U.S. middle market buyouts and complain that private equity's historic outperformance of public markets has diminished in recent years, Hamilton Lane statistics indicate that U.S. middle market buyouts are the slowest growing private markets asset class in the U.S. over the last six years by number of PPMs received. Interestingly, Hamilton Lane observes that despite the absolute growth of small and mid-size buyout funds globally, this asset class has declined as a proportion of all private markets funds. Another factor that augurs in favor of continuing health of the fundraising market is that, according to a recent BlackRock survey of global institutional clients, almost four times as many expect to increase their allocations to private markets than decrease them.

As the industry continues to mature, it is logical to continue to see a broader array of choices (e.g., by industry, stage, size, and geography) to attract LPs to this illiquid asset class. And as Bain & Company estimates that shadow capital adds at least 15% to the amount of capital committed to alternatives and co-invest continues to increase, one cannot help but wonder whether the decline of flows into the U.S. buyout middle market may be somewhat overstated.

Increased sophistication of GPs and developing relationships with management teams well in advance of a potential liquidity event will also be a differentiator in returns.

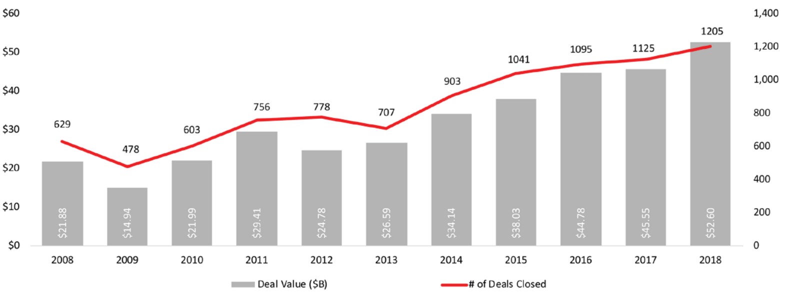
Rapid industry consolidations, buy-and build, and add-on strategies are expected to bolster U.S. buyout middle market activity during 2019. And as the amount of dry powder raised by larger funds remains at record levels, secondary buyouts are expected to significantly bolster middle market buyout activity in 2019.

Deal Activity

Strenghtened by record dry powder, accommodative credit markets, and a historically long period of uninterrupted economic growth, and consistent with overall U.S. and global M&A transaction activity, the U.S. buyout middle market and the sub-$1B subsector set all-time records during 2018 for annual deal value and count. While deal activity for the overall U.S. buyout middle market was stronger in each quarter during 2018 compared to the prior year, deal activity for the sub-$1B subsector declined during the second half of 2018 compared to the prior year. Acquisition activity in the sub-$1B subsector as a percentage of the U.S. buyout middle market continued its slight decline for the third year.

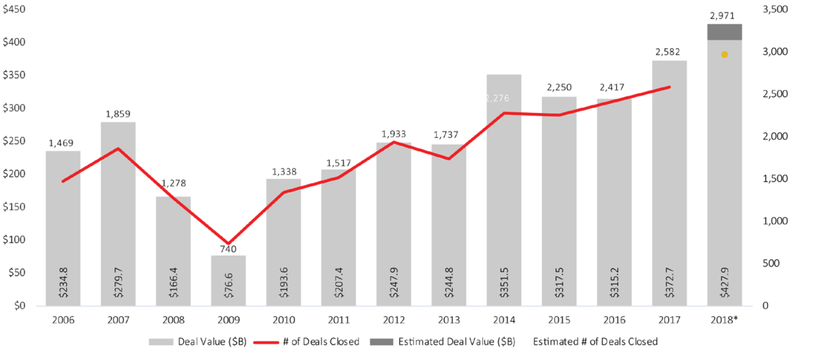
Deal activity during 2019 likely will continue to be highly correlated with the continuation of the factors that led to a decrease in deal activity in the sub-$1B subsector: tightening credit markets, rising interest rates, increasing market volatility, and increasing political uncertainty and geopolitical tension.

US PE activity by year (Akerman methodology)



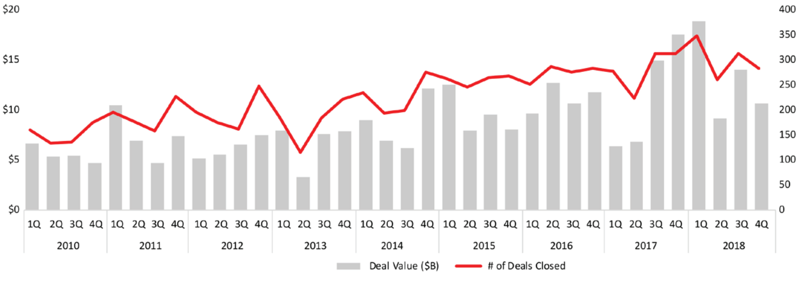
Source: Pitchbook

US PE MM deal activity by year (PitchBook methodology)



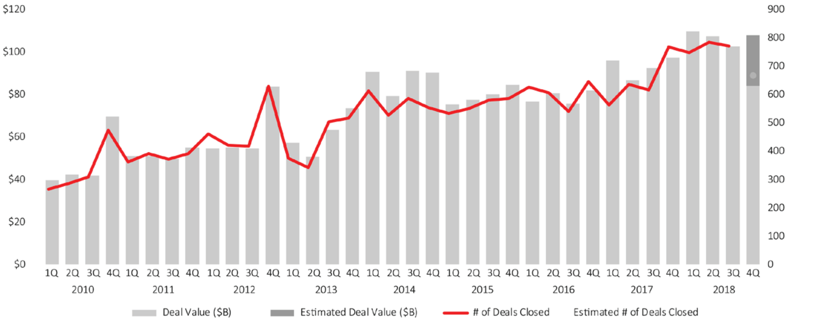
Source: Pitchbook

US PE activity by quarter (Akerman methodology)



Source: Pitchbook

US PE MM deal activity by quarter (PitchBook methodology)

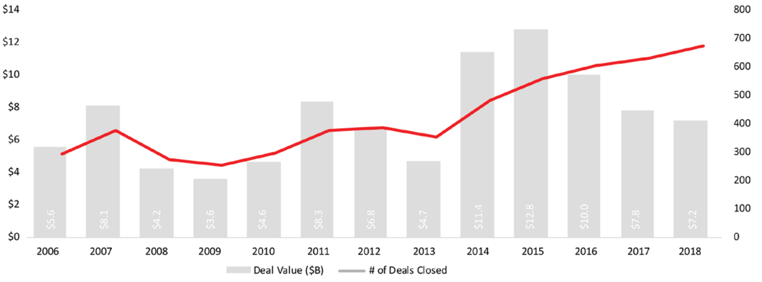


Source: Pitchbook

Add-Ons

The number of add-ons during 2018 in the sub-$1B subsector grew to an all-time record, while the aggregate value of add-ons declined for the fourth consecutive year – reflecting a trend towards more and smaller add-ons.

US PE add-on deals (Akerman methodology)

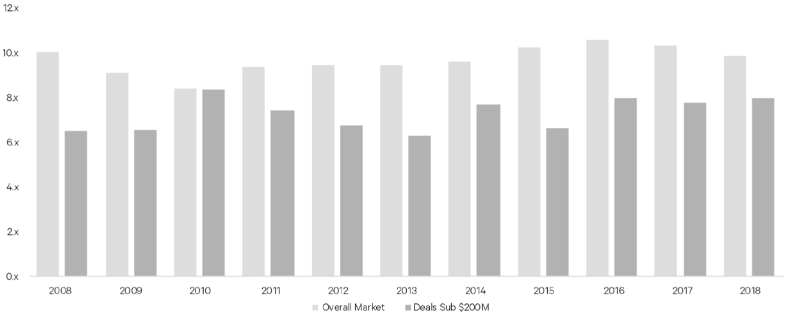


Source: Pitchbook

Valuation Multiples

Valuation/EBITDA multiples in the U.S. buyout middle market remain at historically rich levels, in large part due to the factors that drove record deal activity. Valuation/EBITDA multiples for the sub-$1B subsector increased marginally during 2018 to the near record highs of 2016, while these valuation multiples for the overall U.S. buyout middle market experienced a second year of marginal declines. While the valuation multiples for these asset classes has narrowed, there remains room for multiple expansion as multiples for the broader U.S. buyout middle market remained almost two turns higher on average than for the sub-$1B subsector.

US PE valuation/EBITDA multiples (Akerman methodology)

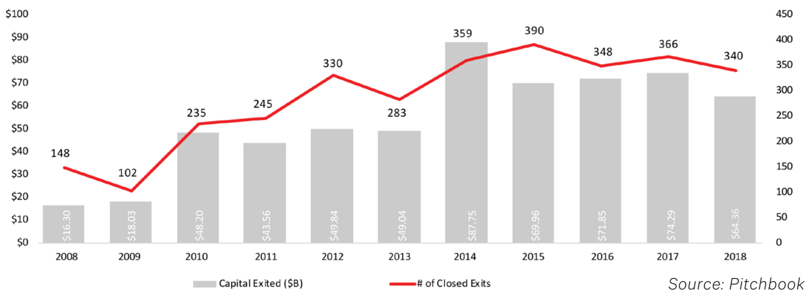


Source: Pitchbook

Exits

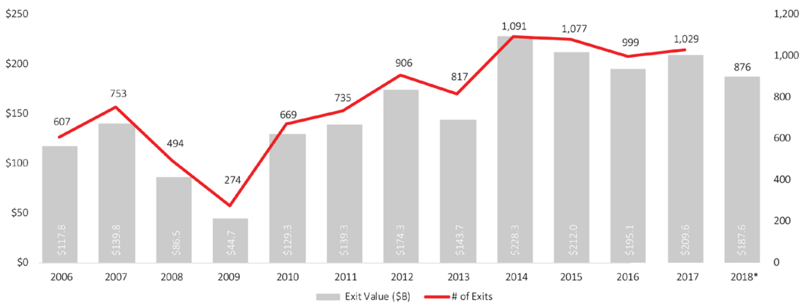
While exit activity has experienced tailwinds from heightened acquisition activity since the Great Recession, longer hold periods and the factors noted above that adversely impacted acquisition activity during the second half of 2018 are creating headwinds. While exit activity remains at historically healthy levels, exit activity for U.S. sub-$1B buyout funds and the overall U.S. buyout middle market declined during 2018 compared to the prior year. Notably, the proportion of exited deals in the sub-$1B subector has increased in recent years vis-a-vis the overall U.S. buyout middle market, the reverse of the trend in aggregate exit value.

US PE exit activity by year (Akerman methodology)



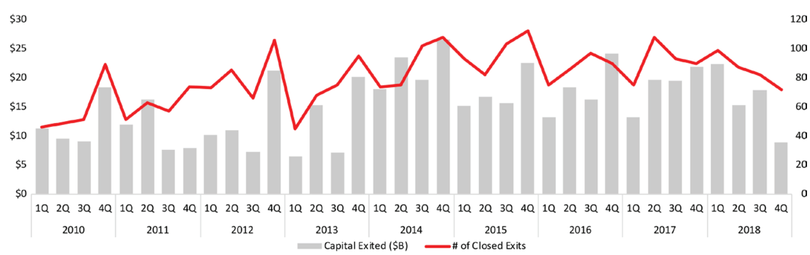
Source: Pitchbook

US PE-backed MM exits (PitchBook methodology)



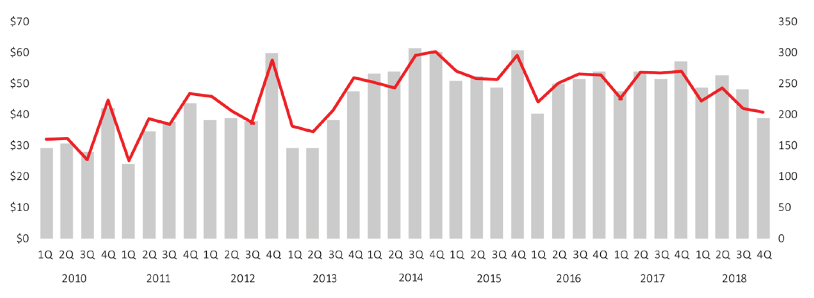
Source: Pitchbook

US PE exit activity by quarter (Akerman methodology)



Source: Pitchbook

US PE-backed MM exits (PitchBook methodology)

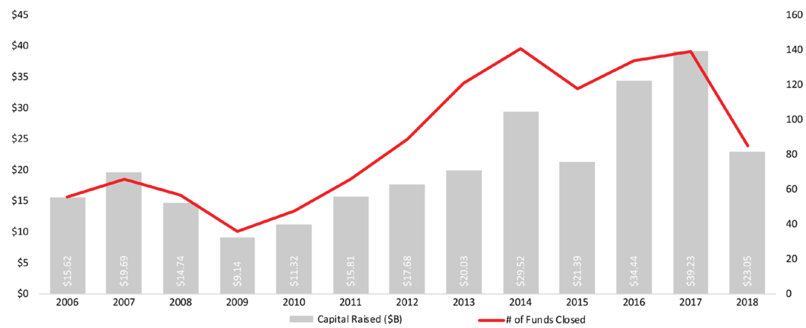


Source: Pitchbook

Fundraising

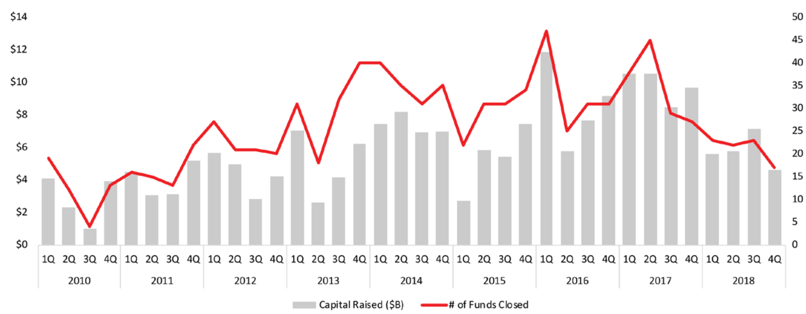
During 2018, for both the US buyout middle market and the sub-$1B subsector, the number of funds and aggregate dollars raised by those funds declined by approximately 40%. The decline for sub-$250M funds was substantially less pronounced during 2018 than was the case for larger U.S. middle market buyout funds. This decline was in large part due to the record levels of dry powder, concerns about the age of the economic cycle, a narrowing of the out-performance of the asset class compared to public markets, and unease with GP economics. First-time fundraising, however, fared much better during 2018, with an approximate 16% increase in the value raised and only a 10% decrease in the number of funds raised – such amounts being the second highest number and value of first time funds raised in any year. What the statistics do not reflect is the strategy shift among some LPs to invest in more sectors or geography-specific funds, and smaller, niche strategies that are large enough for an expansive set of targets but nimble enough to invest effectively. Nonetheless, the demand from other LPs to put increasingly larger amounts of capital to work efficiently, creates relative headwinds in fundraising for smaller funds. Looking forward, the tug-of-war will continue between concerns of investors about high valuations, economic cyclicality, and a reversion to the mean for interest rates and the historical risk-adjusted out-performance of this asset class.

US PE MM fundraising by year (PitchBook methodology)



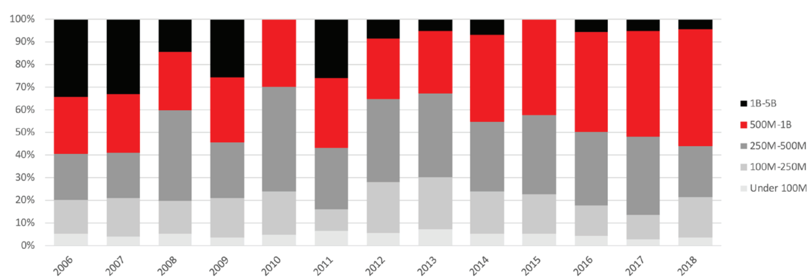
Source: Pitchbook

US PE MM fundraising by quarter (PitchBook methodology)



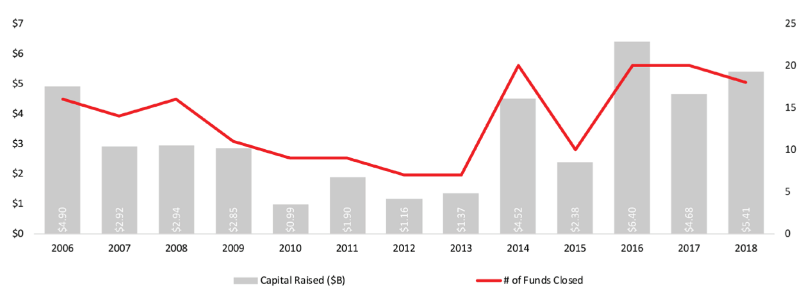
Source: Pitchbook

US PE MM fundraising by size ($B)



Source: Pitchbook

US PE first-time fundraising by size



Source: Pitchbook

Private Equity Funds Should Consider the Qualified Opportunity Zone Program

By Alexandre M. Denault, Tax Partner, Akerman LLP, Miami, Florida, and Ira B. Stechel, Tax Partner, Akerman LLP, New York, New York

Not only can private equity (PE) funds[1] and their investors take advantage of the federal tax benefits under the new qualified opportunity zone (the QOZ) program, in many cases they are uniquely positioned to do so better than any other type of investor. This stems from the fact that the QOZ program is not just for real estate projects, but can apply to a wide variety of business types with which PE funds are familiar, including traditional manufacturing and sales-based businesses, as well as technology-based businesses and start-ups. However, there are some unique issues that PE funds should consider when deciding whether to take advantage of the QOZ program.[2]

Brief Background of the QOZ Program

Under the QOZ program, a taxpayer that reinvests capital gains in exchange for equity in a qualified opportunity fund (a QOF)[3] within 180 days may elect to defer the income inclusion of the capital gain (known as the deferral election) until the earlier of the date they sell their interests in the QOF or December 31, 2026. In addition, an investor of capital gain that holds an interest in a QOF for at least five years can increase its basis by 10% of the deferred capital gain, with another 5% increase after a seven-year holding period, effectively eliminating the eventual inclusion of up to 15% of the initial capital gain invested into the QOF. And, most importantly, provided the taxpayer made the deferral election, then after a 10-year holding period, the taxpayer is entitled to elect to step-up its basis in the equity of the QOF to fair market value, which may have the effect of excluding from federal income tax all of the post-investment gain from the sale of the QOF investment.[4]

Who Should Invest? The PE Fund or its Partners?

If a PE fund sells assets and realizes a capital gain, the parties have the flexibility to choose whether the PE fund or the partners are going to make the deferral election to take advantage of the QOZ program. If the PE fund makes the deferral election, it has 180 days from the date of the sale to reinvest funds into a QOF. Alternatively, if a PE fund does not make the deferral election for itself, the partners of the PE fund may do so on a partner-by-partner basis. In this case, partners have more timing options. The partners have 180 days from (i) the date of the realization of the capital gain by the PE fund or (ii) from the end of the taxable year of the PE fund, in which to invest their allocable share of the capital gain into a QOF.

This flexibility requires timely communication between the PE fund and the partners to ensure that there is coordination about whether the PE fund or the partners will take advantage of the QOZ program. In addition, if a partner makes the deferral election, the partner will need to ensure it has adequate liquidity to make the actual monetary investment into a QOF. In certain cases, this may require the PE fund to make distributions to the partners.

Practical Limitations on Business Choice

A QOF must carefully choose what type of business to acquire to ensure that it meets all of the requirements under the QOZ program. Because qualifying businesses generally need to have a link to the geographic area comprising a qualified opportunity zone, this may limit what types of businesses can be acquired as well as the ability of the business to expand outside of the opportunity zone.

Specifically, the QOZ statute requires that at least 50% of the gross income of a QOZ business be derived from the active conduct

of a trade or business. To date, the Treasury has provided no definition as to what constitutes the "active" conduct of a trade or business. For example, will a start-up period or a research and development phase be permissible and count as "active" conduct? Equally frustrating is the guidance on the sourcing of income for purposes of the 50% test, so as to differentiate between "good" income derived from sources within the QOZ, as opposed to "bad" income derived from sources outside the QOZ – a determination relatively easy to make in the case of income derived from real estate operations but much less so in the case of a manufacturing or service business. In this respect, a bipartisan group of 16 House and Senate legislators wrote a letter to Treasury in January requesting the amelioration of the sourcing rule to simply require that 50% or more of the gross income of a qualifying business come from the active conduct of a trade or business.

Similarly, the 31-month working capital safe harbor period provided within the Proposed Regulations for QOFs investing in a subsidiary conducting a qualifying business that acquires, constructs or rehabilitates tangible business property is an extremely useful provision for real property development projects but much less so for non-real estate businesses. Accordingly, the ABA Tax Section has recommended to the Treasury that the working capital safe harbor period be revised to permit the use of working capital assets to fund the operating costs of a new or expanding non-real estate business, as well.

When a PE fund acquires a business, part of the consideration is typically allocated to goodwill. Goodwill is an intangible asset, and the PE fund typically amortizes the goodwill over 15 years, providing valuable income tax deductions during the holding period of the goodwill and the business. How goodwill affects a QOF structure depends on the structure of the QOF investment and the relative value of the goodwill in relation to the other property of the QOF. In general, a QOF may directly own goodwill provided the value is less than 10% of the overall value of all of the QOF's property. For a QOF which indirectly owns the goodwill through a subsidiary entity treated as a partnership or corporation for tax purposes, the subsidiary may own an unlimited amount of intangible assets (including goodwill) provided that a substantial portion of the intangible property is used in an active trade or business.[5]

Structure and Carried Interest

A QOF needs to ensure that it structures the acquisition of a business in a way that qualifies under the QOZ program. For example, if a PE fund creates a QOF and seeks to purchase a business which is treated as a C corporation for tax purposes, the QOF cannot simply purchase the stock. Instead, the acquisition would need to be structured to comply with the QOZ program. One way to accomplish this is for the QOF to form a subsidiary C corporation, make an equity funding of the C corporation with cash, and then have the C corporation acquire the assets of the business. Careful planning is also needed when acquiring a business treated as a partnership for tax purposes.

Moreover, a QOF should consider whether to invest only in a single-business as opposed to having multiple businesses under the same QOF. Using a single-business model should make it easier to sell the QOF equity interests to a buyer on exit, but would come at the expense of diversification.

While there are still some open issues about the extent to which a carried interest can qualify for the income tax benefits under the QOZ program, if a QOF deal will be structured with a carried interest, it is important to ensure that the person or entity receiving the carried interest will invest capital gain into the QOF within 180 days just like the other investors. The existence of the capital gain investment is a critical element to qualify for any income tax benefit under the QOZ program.

PE funds will also need to consider whether their QOF deal will permit or require distributions over time (especially to cover the investors' deferred income inclusion on December 31, 2026), how to deal with structured or delayed capital raises, and what limitations on investor-level QOF disposition rights (such as drag, tag, and buy-sell rights) are acceptable to ensure the investors can qualify for the maximum income tax benefits under the QOZ program.

The Proposed Regulations also have yet to deal with the manner or timing of the reinvestment of proceeds from the sale or other disposition of QOF subsidiaries or business assets. The statute clearly anticipates the reinvestment of

such proceeds and specifically authorizes the promulgation of regulations to insure that a QOF has a reasonable period to effectuate such reinvestment, but provides no guidance as to whether such reinvestment maintains ongoing deferral, such that no gain is recognized. Presumably, the legislative intention was to permit ongoing deferral on the part of investors, who neither sell their interest in the QOF before meeting the 10-year holding period nor receive distributions from the QOF which essentially cash out their interests. The next set of Proposed Regulations will likely address these issues.

Takeaways

Non-real estate heavy businesses, including traditional manufacturing and sales-based businesses, as well as most types of start-up businesses and technology companies, have largely been overlooked as potential QOF investments primarily because most of the discussion has centered on real estate projects. PE funds are in a unique position to invest in operating and start-up businesses under the QOZ program due to their industry knowledge and experience in acquiring those types of businesses. However, PE funds need to be aware of the special QOZ program requirements that, in many cases, will change the way in which deals are selected and structured.

Finally, PE funds should carefully consider whether the long-term holding periods required to obtain the tax benefits under the QOZ program are realistic. The most significant tax benefit is that after a 10-year hold, an investor can make an election to step-up the basis of the investment in the QOF to fair market value, which could result in no taxable gain upon the exit (exit being a sale of the QOF equity interests). PE funds will need to determine whether such a holding period is consistent with its investment objectives and philosophy, as well as whether to invest in a QOF through the existing PE fund structure or through a separate, standalone structure.

FOOTNOTES

1 This article defines a PE fund as an entity, such as an LP or LLC, that is treated as a partnership for federal tax purposes.

2 The QOZ program is in its infancy, with several rounds of Treasury Regulations forthcoming, the release of which should accelerate investment under the QOZ program. Investors therefore could face some degree of legal and tax uncertainty prior to the issuance of further guidance in certain cases depending on their structure and investments. This article summarizes the current state of the law and related guidance, some of which is ambiguous and subject to change.

3 A QOF is generally an entity treated as a partnership or corporation for tax purposes (which can include an LLC) formed for the purpose of investing in qualifying opportunity zone businesses or property. A QOF must meet several other tests and timing requirements in order to qualify under the QOZ program. Anyone can create a QOF, including a PE fund or its partners.

4 However, under current guidance, capital gain or ordinary income may arise on exit when a QOF that is treated as a partnership has debt or "hot assets" (such as inventory and depreciation recapture) when the QOF equity is sold even after a 10-year hold. Also, whether these benefits apply for state income tax purposes depends on whether a state conforms to the federal law and is determined on a state-by-state basis. Operating income earned by the QOF during the holding period is generally subject to income tax under normal income tax principles.

5 The Proposed Regulations provide that the intangible property must be used "in the qualified opportunity zone;" however, the statute does not clearly require this. It is an open question whether Treasury will retain this requirement in Final Regulations.