How to Take Advantage of the 'New Golden Age' of Private Equity

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We are living in another golden age of private equity according to many experts. Private equity managers raised $453 billion from investors in 2017—breaking the record set in 2007—and the trend in 2018 has been more of the same. Based on the growth of the past few years, and assuming a conservative 8% annual compound growth rate, private equity is projected to overtake hedge funds in assets under management within five years.

Private equity largely owes its rise to an extended period of historically low interest rates. Impatient with low yields in the public space, investors increasingly have turned to debt funds, buyouts and other private assets for stronger potential returns. The influx of cash in the private space, coupled with the benefits of private ownership such as more efficient board meetings and executives with a greater personal stake in profitability, has fed the trend of large companies being acquired by private equity firms.

However, private equity's growth has attracted the attention of federal regulators, who are concerned about the shrinking of public markets. For example, earlier this year the Committee on Foreign Investment in the United States spoke out against Broadcom's prospective takeover of Qualcomm, citing its fear that Broadcom would run the company in a "private equity style" that emphasized short-term profits over long-term research and development investment.

Buyers and sellers in private equity also must reckon with changes brought by the Tax Cuts and Jobs Act of 2017. The sweeping tax overhaul includes several provisions relevant to private equity investment strategies, such as an increase in the holding period for long-term capital gains with carried interest, restrictions on some deductions and the expansion of others.

What opportunities does this evolving market offer for investors, lenders and recipients of private capital, and how are firms adapting to the prevailing trend? Crain's Custom turned to two seasoned private equity professionals to learn what the changes mean, and whether the TCJA has been a net positive or negative for the industry:

John Ruckstuhl, managing director in the transaction advisory services group of EisnerAmper LLP. For more than 20 years, he has advised private equity and venture capital firms on their domestic and international transactions.

Matthew McNally, managing director in the asset management tax practice group in the New York office of True Partners Consulting LLC. He works with private equity firms, portfolio companies, hedge funds and venture capital firms..

Crain's: What are some of the more significant challenges facing private equity buyers looking to complete transactions before the end of the year?

Ruckstuhl: We've seen a recent spike in the volume of transactions looking to close before year-end. In order to expedite the process, all of the transaction professionals involved on both sides of the deal—including lawyers, accountants, lenders and investment bankers—need to be fully committed to the various deadlines in order to meet closing deadlines. It is crucial to understand the lead times required for the various parties to complete credit and investment committee reviews.

Crain's: What are some factors that are either holding up or terminating deals?

McNally: The Tax Cuts and Jobs Act of 2017 has certainly had a significant impact on current and future deals, especially on both debt funds and buyout transactions due to the new limitations on interest expense deductions. Currently, I do not see debt funds or buyout transactions becoming less alluring as long as interest rates remain at historically low levels. If interest rates begin to rise ever more sharply, investment appetites for these funds may begin to wane. The reform has already begun to disrupt how potential buyout targets are valued and how buyout transactions may have to remove some of the leverage. However, the corporate tax cuts may help bolster returns in the future and may offset any adverse consequences the tax reform may have had.

Ruckstuhl: The primary factors that hold up or terminate deals are the financial performance of the target and the language in the purchase agreement. It is not unusual for sellers to take their focus off the operations during the sales process. Sellers need to stay committed to delivering on the near-term projections they provided at the beginning of the process. Sellers also get a first view of the purchase agreement and have to make decisions on the terms. We also see sellers getting their tax advisers involved late in the process, resulting in proposed changes to the structure as the sellers start to focus on the net cash they anticipate from the deal.

John Ruckstuhl is a managing director in the transaction advisory services group of EisnerAmper LLP

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Crain's: How are the debt markets influencing private equity transactions?

McNally: The Tax Cuts and Jobs Act generally restricts net business interest expense deductions to 30% of adjusted taxable income. "Adjusted Taxable Income" is essentially equal to EBITDA (the taxable income of the taxpayer computed without regard to deductions allowable for net interest expense, net operating losses, depreciation, amortization or depletion) but is decreased to EBIT for tax years beginning after Dec. 31, 2021. The decrease will further limit the interest expense deductions starting 2022. The limitation does not apply to businesses with average gross receipts of $25 million or less, particularly regulated public utilities and real property businesses.

Prior to the law change, there was no limitation and private equity firms had unrestricted leverage limitations when conducting a buyout. This could substantially impact the debt markets, private equity firms and portfolio companies. Essentially, the cost of debt will effectively increase, because firms no longer get the full benefit of what can be a massive tax write-off. Borrowers should contemplate repaying existing debt, and companies accessing capital markets might want to consider increasing their equity capitalization compared to their debt.

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Crain's: Matthew, you brought up the Tax Cuts and Jobs Act of 2017. In what ways has the new law set the private equity industry back, and what opportunities has it created?

McNally: There can be no denying that the TCJA has significantly changed the private equity industry. Under the new law, long-term capital gain treatment on gains associated with a carried interest is generally limited to the sale of underlying property with a holding period greater than three years. Gains related to carried interests with less than the three-year holding period will be reported as short-term capital gains. Carried interests held by corporations are not subject to the new rules. When it comes to S corporations, the IRS recently announced that it plans to release "regulations clarifying that taxpayers will not be able to circumvent the three-year rule by using 'S corporations.'"

The TCJA also limits deductions for losses and restricts interest deductibility at 30% of gross earnings, thus making debt less attractive. However, the reform's positives far outweigh the negatives. For example, the new law grants substantial deductions for capital expenditure and lowers the corporate tax rate from 35% to 21%. These two changes alone should raise the value of U.S. portfolio companies and lead to extensive opportunities and increased gains for private equity firms currently holding U.S. corporations.

Crain's: How has the TCJA affected the interplay between private equity-owned companies and the PE firms themselves?

McNally: The private equity fund managers will have to consider their specific circumstances and the impact to the specific portfolio companies. Under the new tax regulations, the co-investment vehicles and control of portfolio companies could cause an increase in reporting and income pick-up at the fund level, even before investment returns are ever distributed. The portfolio companies will become increasingly reliant on PE fund managers to help them with the interplay of all these issues to make the right decisions. The TCJA has far-reaching implications for almost every U.S. partnership and corporation. Those implications will quickly develop as the IRS and other authorities begin releasing guidance. Private company and PE fund managers will need to continue to work together to track these issues and make decisions that are mutually beneficial.

Crain's: How are longer holding periods for private equity investments affecting the marketplace?

Matthew John McNally is a partner and head of the New York City asset management tax practice of True Partners Consulting LLC

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Ruckstuhl: The average holding period for a PE-owned company is now in excess of six years, according to PitchBook. These longer periods allow the private equity group more time to implement strategic changes and integrate bolt-on acquisitions that should help increase the earnings and, thus, the valuation of the business upon exit. The bolt-on strategy has become a key component to increasing the value of a portfolio company over the last few years. The ability to exit many of these companies is also impacted by an overall reduction in the number of IPOs over the past several years. Size and scale, let alone an increase in market volatility, are important considerations in whether the IPO exit is likely.

McNally: As mentioned, PE firms keep the portfolio company investments in their funds an average of five to six years. During this time period the PE firm focuses on increasing the value of the company through operational enhancements, growing the company's market position and increasing the return on equity capital through leverage. After the PE firm sells the portfolio company the proceeds are then distributed to the investors (limited partners), who are then free to invest the funds back in new private equity funds or other investment vehicles. Therefore, a prolonged private equity holding period can have an adverse impact on the private equity firm if the additional time was not adequately planned.

Long-hold private equity vehicles have just begun to gain popularity and at this point it is too soon to say how attractive they may eventually become. Taxable investors who are interested in longer-term strategies can help PE firms compete more effectively for assets against corporate buyers. If a business owner is considering a PE firm as a prospective buyer, they would be more inclined to sell if they knew the business was not going to be flipped for a profit as soon as possible.

Crain's: What are the implications of the new rules regarding the sale of partnership interest by a foreign partner?

McNally: The TCJA added a requirement for the acquirer (buyer) of a partnership interest to withhold a 10% tax on the amount realized on the transfer unless the transferor (seller) gives a certificate (typically Form W-8 or W-9) to the buyer stating that the seller is not subject to withholding. If the buyer does not withhold the tax, the partnership must withhold from distributions to the transferee until the outstanding withholding tax (plus interest) has been satisfied. The new law also provides that gains or losses from the sale, exchange or other disposition of a partnership interest are effectively connected with a U.S. trade or business to the extent that a partner that is a foreign individual or foreign corporation would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange. Therefore, a partnership, whether U.S. or foreign, that transfers such interests is required to treat the applicable amount of gain or loss as effectively connected income (ECI) and withhold on this amount with regard to any foreign partner under section 1446.

Crain's: Sell-side financial due diligence has become more prominent. How prepared are sellers from a tax perspective?

Ruckstuhl: Many sellers focus on the gross (rather than the net) amount of the transaction proceeds. This often leads to missed structuring opportunities. Issues specific to the transaction, such as the determination of nexus and appropriate state and local matters, are often left to the buyer to identify. Sellers typically know there are some exposures, but they fail to quantify and address them proactively.

McNally: The earlier a private equity firm gets their advisory team involved in the performance of sell-side financial due diligence the more value they will receive. I have on many occasions watched as management has had to scramble to provide information that could have been readily available if they would have worked with their tax adviser prior to the sale. A good tax adviser can help to identify key tax issues and errors in advance of the buy-side advisers getting involved. This will help relieve unnecessary stress and prevent adverse implications on deal price and potentially stop the deal from being killed.