Transaction & Integration Services

Private Equity Investors

Rethinking Strategy in the Current Economy

Overview of Current Market and Private Equity Strategy

The COVID-19 pandemic has created a sudden market disruption that has forced private equity investors ("PEIs") to reassess their planning for portfolio company investments ("PortCos") and rethink strategic approaches for current and future pursuits. Though many uncertainties exist, PEIs are well-positioned to respond to the current market conditions, particularly in light of lessons learned from the 2007-2009 financial downturn, the devaluation of companies across various sectors, and the availability of existing fund commitments, or "dry powder" is estimated to be trillions in uncalled capital.[1]

Changes in market conditions may provide more opportunities for exclusivity periods on certain pursuits or increase avenues to pursue letters of intent to claim first rights or commitments to bid on investments. For auction bids during the economic decline, PEIs may also benefit from less competition among willing and able strategic buyers in the marketplace. Though market conditions may be disadvantageous for strategic buyers, the available purchasing power at PEIs' disposal, combined with proper strategic investment considerations, can generate tangible positive results to see PEIs through the pandemic and position them for future success post-pandemic. Certain market opportunities may introduce PEIs to a number of transactional structures that involve varying tax planning considerations and pitfalls to manage.

Types of Transactions and Tax Considerations

The types of transactions often pursued by PEIs during economic downturns may include but are not limited to: (i) acquisitions of carve-out business divisions; (ii) divestitures to monetize assets or investments; and (iii) Private Investments in Public Equity ("PIPE") deals, and (iv) purchases or sales of distressed companies or their assets. PEIs and underlying PortCos may also encounter situations where current or future pursuits are abandoned.

Acquisition of Carve-out Business Divisions

One approach PEIs may consider is acquiring, at a lower purchase price, the carve-out assets or business divisions of companies that are desperate to generate cash flow. Acquisition of carve-out business divisions to "bolt-on and build-up" the value of existing PortCos may present an opportunity to add value quickly. Though this opportunity can be valuable, there are many operational complexities to consider when executing a successful integration of a carve-out business division. Challenges may include (i) a growing footprint in numerous and varied global

[1] Source: Bain & Company Brief "The Impact of Covid-19 on Private Equity" dated April 9, 2020.

jurisdictions, (ii) new legal entity stand-up and operationalization requirements (i.e., Day 1 readiness), (iii) complex tax structure considerations, (iv) tax attribute management and preservation, and (v) considerations on location of intellectual property ("IP"). Proper identification and planning of relevant tax considerations enables the PortCo tax department to navigate pitfalls and paves the roadway to effectively manage and improve the PortCos tax profile.

Divestitures to Monetize

Another method to bolster the success of PEIs in the current market is to consider divestiture of currently owned distressed PortCos (or PortCo business assets or divisions). This may be especially true if companies in distressed market sectors, such as oil and gas, retail, and hospitality and entertainment, constitute significant portions of a PEI's portfolio. Disposing of companies through an appropriately planned transaction, whether through carve-out, spin-off, or another means of tax efficient planning, may have beneficial results on EBITDA and generate tax mechanisms for PEIs' future use. Separating assets or businesses can involve similar pitfalls, considerations, and stand-up requirements as integrating an acquisition, but the process often poses increased Day-1 readiness urgency for the seller. Spin-off separations can be both taxable and non-taxable—although a tax-free divestiture may be possible, PEI ownership and exit models may create unique issues to navigate under the complex spin-off tax rules.

PIPE Deals

As PEIs consider investment in PIPE deals, it is important to be cognizant of the form of consideration through which PEIs maintain ownership in PortCos. PEIs that prefer controlling equity stakes in PortCos may seek minority ownership investments through an instrument that provides the upside benefits of an equity owner with the downside protection of a creditor through priority liquidation preference. The tax considerations are varied and can depend on whether ownership is in the form of stock or in other securities, such as options, warrants, convertible securities, or debt. Without proper analysis, a seemingly advantageous purchase may cause limitations on the PortCo's use of tax attributes to offset income. The terms of certain instruments must also be carefully structured to ensure that the holder does not realize "phantom income" over the life of the instrument as a result of original issue discount.

Distressed Companies

PEIs may seek to expand their pursuit of more unique investment strategies arising as a result of the economic uncertainty. For example, PEIs may contemplate acquisition of PortCos in a specific phase of the distressed lifecycle, such as those (i) showing signs of initial underperformance, (ii) in a state of technical default, (iii) insolvent, or (iv) considering Chapter 11 bankruptcy. PEIs will need to manage tax considerations associated with these strategic alternatives, such as internal restructurings, tax attribute preservation, and value management. In other cases, PEIs may turn to purchasing distressed debt in the marketplace at less than face value with a goal towards benefiting upon turn-around. Purchasing such debt from a PortCo that is considered a "related party" under complex tax rules can pose unique tax considerations for the issuer and the PEI holder that can generate undesirable "phantom income".

Abandonment of Current or Future Pursuits

As a result of the sudden and unexpected downturn, many deals may be paused or outright abandoned. Depending on the course of action, certain fees paid by PortCos to third-party service providers to pursue a transaction that is ultimately abandoned may be recoverable either as ordinary deductions or capital losses. The character and timing of the deduction is dependent upon the facts and circumstances of the identifiable events giving rise to the abandonment.

Future Tax Efficiency and Tax Planning

In addition to pursuing acquisitions or divestitures, PEIs may also look inward to their PortCos and consider (i) internal restructuring, (ii) IP migration, (iii) Chapter 11 bankruptcy, or (iv) utilization of acquired or organically generated tax attributes.

Internal Restructuring

The markets experienced unprecedented highs in recent years and may have resulted in PEIs acquiring companies at a rate that left limited time for legal entity review. During the economic downturn, PEIs may want to review their legal entity structure to clean up redundant or dormant entities or identify potential cash tax savings through internal restructuring. Though there are short-term costs associated with this type of analysis, the long-term benefits to restructuring, revenue reporting, and tax savings may ultimately save money (or increase 5-year NOL carry-back opportunities, an enhanced benefit through 2020 provided by the Coronavirus Aid, Relief, and Economic Security ("CARES") Act) and help prepare PortCos for future transactional, functional, and strategic success.

IP Migration

The current market sets the stage for unique conditions for IP restructuring and monetization. Pursuant to the Tax Cuts and Jobs Act ("TCJA"), the U.S. decreased domestic tax rates for corporations to 21%. At the same time, experience from other recent economic downturns would tell us that there is a window of opportunity where IP valuations may be lower because of globally depressed markets. Reduced tax rates combined with globally depressed markets that potentially lower IP value could facilitate the restructure of IP in a cost-efficient manner. Migrating IP may enhance global tax profiles, reduce a PortCo's effective tax rate, increase future cash tax savings, and appropriately align IP with the company's go-forward operational strategy.

Chapter 11 Bankruptcy

Depending on the operating conditions of a distressed PortCo, formal declaration of Chapter 11 bankruptcy may be a consideration for some investments. Prior to filing petitions for an in-court restructuring, PortCos may contemplate various restructuring alternatives and each alternative may have unique tax implications, including the amount of cancellation of debt income ("CODI"), attribute limitation, and go-forward availability of tax attributes, which may impact cash tax forecasts. To that end, PEIs may have the ability to claim a worthless stock deduction with respect to a PortCo, with the capital loss utilized to offset capital gains and potential for investors to carryback or carryforward losses.

In order to successfully claim such a worthless stock deduction, PEIs need to carefully consider the timing and the steps associated with the bankruptcy proceedings. For example, the market may see a significant increase in bankruptcy filings during Q3 and Q4 of 2020, but these bankruptcies may not be completed until sometime in 2021, which will raise questions on the timing of worthlessness. Timing is particularly important for a series of events that span more than one period and establishing worthlessness in a tax year prior to completion of the bankruptcy process requires careful consideration of the facts.

Tax Attributes

In response to the COVID-19 pandemic, the U.S. government has enacted the CARES Act. The CARES Act in tandem with the TCJA has resulted in proposed tax legislative provisions and IRS guidance that directly impacts tax attributes and attribute planning matters that PEIs and PortCos should consider. For example:

> CODI: Significant modifications of indebtedness will be subject to complex governing tax rules and can give rise to taxable CODI to PortCos, unless an exception such as insolvency or Chapter 11 bankruptcy applies.
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> Earnings and Profits ("E&P") and Stock Basis: PEIs and PortCos may benefit from analysis and computations of tax-based E&P, stock basis, and accounting for income taxes with respect to financial reporting. In particular, the CARES Act retroactively allows carrybacks for NOLs generated in 2018 and 2019, which raises questions on the timing of related E&P adjustments that could impact the tax characterization of prior cash distributions.
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> Net Operating Losses ("NOLs"): A PortCo that has generated NOLs may be able to offset any CODI with available NOLs. Therefore, it is important for PEIs and PortCos to determine NOL usage and limitations and analyze whether a current usage or carryback of NOLs to offset CODI is more beneficial. Further, under the CARES Act, NOLs incurred in 2018, 2019, and 2020 could offset 100% of prior-year taxable income, with potentially larger cash refunds for tax years prior to 2018, based on a 35% corporate tax rate (a 14% rate arbitrage benefit).

Final Thoughts

The M&A market has seen a significant decrease in volume since the onset of the COVID-19 pandemic including increased risk of success of deals in process, additional considerations required during due diligence, and delays due to liquidity, regulatory and other reasons. However, whether the pandemic is a short-term or long-term reality, PEIs still have an opportunity to capture value in this environment and have many tools at their disposal to appropriately strategize and navigate the complex tax issues encountered on the path forward. For many years, our professionals have been in the forefront of turnaround and restructuring transactions, as well as advising both distressed companies and strategic and financial buyers as they navigate the challenges of undertaking strategies to effectively manage or improve their tax profile. Our approach and extensive experience with these transactions and associated tax considerations position our team to effectively assist PEIs and their PortCos address their tax needs.

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