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Crystal Ball Gazing Into The World Of Private Equity – 2013

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The Editor interviews ***Adam K. Weinstein****, Partner in the New York City office,* ***Robert J. Leonard*** *and* ***Fadi G. Samman****, Partners in the Washington, DC office of Akin Gump Strauss Hauer & Feld LLP.*

Editor: Would you each describe your respective practices at Akin Gump?

Samman: My practice focuses on the formation of domestic and international private funds, representing sponsors in the organization, structuring and operation of private investment funds, including buy-out funds, credit funds, real estate funds and venture capital funds. I spend a significant portion of my time representing institutional investors investing in private funds as well.

Weinstein: I am a partner in the corporate group in the New York office, focusing primarily on private equity and public and private mergers and acquisitions. I represent investment funds and their portfolio companies in buying and selling companies, providing equity investments and advising the fund sponsors, their portfolio companies and boards of directors on corporate governance and liquidity matters, refinancings, joint ventures and other transactions. One of my principal clients is a mega-cap private equity fund.

Leonard: I am a partner in the firm's Washington, DC office, and my practice focuses primarily on tax policy and budget policy issues. We have a wide variety of tax policy clients, including many clients in the funds industry. We basically advise clients' funds, primarily private equity funds, on matters of concern and interest in the tax policy area, including the tax ramifications of the fiscal cliff and possible changes to the tax treatment of carried interest.

Editor: How is the fiscal cliff affecting private equity deals?

Leonard: There is tremendous uncertainty and much at stake economically with respect to the fiscal cliff. At the moment, there is no clear direction on how these many issues will be resolved, but the primary issues that we are following on behalf of funds clients include the top marginal tax rate, currently at 35 percent anticipated to increase to 39.6 percent on January 1, 2013. Other rate issues include: (1) the capital gains rate, currently at 15 percent expected to rise to 20 percent; (2) the dividend rate, currently at 15 percent expected to rise to 39.6 percent for top-tier incomes; (3) and the new so-called investment income tax of 3.8 percent that was enacted as part of the

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Affordable Care Act in 2010. That particular tax was enacted with a delayed effective date and will now take effect on January 1, 2013. Resolution of all these issues - marginal tax rates on ordinary income, tax rates on capital gains and dividends – are all uncertain at the moment, and that uncertainty impacts all business transactions, including private equity deals.

Weinstein: Deal activity can be broken into two components: one is the flurry of deal activity occurring now, prior to the potential fiscal cliff, and its accompanying uncertainty, which includes a substantial increase in extraordinary dividends, divestitures and other returns off capital prior to year-end.

The PE funds tend to thrive in uncertain times, but the present uncertainty makes it very hard to see a turnaround in terms of an uptick in deal activity. The uncertainty works well for investors in distressed situations, but other M&A activity seems to be substantially less, which may be owing more to sellers' pricing expectations versus buyers' pricing expectations. Given the present uncertainty, it is very hard to value companies in this market, which operates as a brake on those who are expecting a turnaround.

I think it's not so much a matter of the fiscal cliff, but the interest rate and unemployment that will prevail afterwards. Because we are still in a historically very low interest rate environment, if uncertainty moderates, and interest rates stay low, I would expect you would see a substantial increase in LBO activity with cheap debt financing available in the market. One variable that could affect deal activity going into 2013 is the possibility of a change in the corporate tax rate, resulting in increasing strategic divestitures of non-core assets with companies reallocating capital toward their core businesses and resulting in more deal activity.

Editor: Do you see any more fund formation taking place in this environment?

Samman: The good news in fund formation is that neither the fiscal cliff nor tax policy drives the fundamental question as to whether and when to form a fund. Adam highlighted the fact that the private equity industry is a flexible industry, flocking to opportunity, creating new structures, taking advantage of opportunities. I don't see that changing. Fund formation activity is going to be far more driven by the opportunity set and the economy than it is by the micro issue of the fiscal cliff and current tax rates. The private equity industry has been around for a long time, having been around through a variety of tax rates and tax code changes. I don't expect that to change. Investors continue to see the asset class as one that's important to their portfolio, not purely just for returns, but also as part of a diversified portfolio. It is an important asset class that will continue to receive investors' allocations regardless of some of these issues in the near term.

Weinstein: I think there will be increasing flow toward the larger PE funds for deal activity. The PE funds that can access leverage, that have tax-exempt pension investors, will be less impacted by any changes in the tax rates. Therefore, you'll see continuing allocation for the PE funds from those entities.

Editor: Doesn't liquidity in the market also influence fund formation?

Samman: It certainly does. There is still an overhang of capital that needs to get deployed, but we have seen in the past few months – and will continue to see – more funds come to market. Many of the large managers that we're familiar with have come to market recently. While illiquid, private equity has the advantage of being a long-term hold. I don't see that the issues of today are necessarily the primary focus of investor decisions or frankly that of fund managers.

Editor: Even though pension funds not subject to capital gains taxes will enjoy an advantage in terms of investing in private equity, do you expect there to be a diminution in the number and amount of funds available for private equity?

Samman: I think there will be fewer and smaller funds and, therefore, less money available for private equity – a function of economic reality and obviously a resizing of expectations in the market. We continue to see investors across the spectrum having continued interest in allocation to private equity. I have not seen my investor-side clients' appetites for an allocation to private equity dramatically shift one way or the other. Their focus is more on viewing their portfolios with an eye to the high-quality funds and quality managers that they want to devote their capital to. I think tax-exempt investors have always enjoyed an advantage, whether vis-à-vis private equity or any other investment, of investing on a tax- exempt basis. A very significant portion of private equity capital in the U.S. is tax-exempt in any event.

Leonard: The tax uncertainty associated with the fiscal cliff – which is a matter of intense interest among clients – comes at a price: a cost of economic activity. A lot of what we try to do is to help clients navigate through this time of extreme uncertainty that hopefully will soon be resolved. Of course, once the fiscal cliff is resolved, new uncertainties will be created as tax reform advances on the legislative agenda. That will create a whole new set of uncertainties that will have to be navigated by our funds clients as well as many other clients of the firm.

Editor: Adam, did you have anything more to say on that subject?

Weinstein: There is an increasing focus on the larger funds, which I agree will be smaller in size, but investors are likely to increase their focus on them. In terms of deal activity, there is still a lot of cash on the balance sheets of strategic investors and committed capital for PE funds, with demand for deal activity exceeding the available deals. What does that mean in terms of deal flow? If you don't get runaway pricing from buyers overpaying and increasing the value attributed to the same cash flows, you should see an increased focus on the quality of the PE sponsors. Not only are investors focusing increasingly on the more successful managers, but the target companies in M&A activity are likely to increasingly focus on the quality sponsors, with specific industry experience and a successful track record in executing on deals, to add value to their board, to their exits, to their strategic growth plans and to their ability

to access the debt and equity capital markets. So, you'll see an increasing focus on who the sponsor is, but not necessarily a decrease in the aggregate capital allocated to PE funds.

Editor: What are some available tax mechanisms for enhancing the growth of funds?

Samman: While tax planning has always been a focus for private equity funds in their deal structuring, there is uncertainty regarding what sort of tax strategy will present itself. Obviously, if we have significant tax rate increases and taxation of carried interest, an additional focus by managers on tax planning and tax structuring of their funds will become that much more important in order to make the products more attractive to investors. In terms of tax-driven enhancements driving capital raising, that is a little hard to predict. Coming up with innovative structures to enhance returns could provide a premium to their creators if we are faced with significantly higher tax rates, which seems highly likely.

Weinstein: If there is a drop in the corporate tax rate, there could be a shift toward lower leverage because the benefit of that leverage would decrease, but I think most of the PE sponsors value companies based on EBITDA/ cash flows. So, the tax benefit is a one-time benefit for the cash accumulated by a target company as compared to increasing operating cash flows. Also, the tax impact needs to be balanced against the PE sponsors' desire to maximize their returns in a low interest rate environment, with leverage readily available. It is difficult to measure what tax mechanisms would benefit funds, given the conflicting forces in the market.

Editor: What are the most accessible funding sources for raising private equity? Do you expect all of these to be available under the new, as yet undetermined, tax code for 2013?

Samman: I think one of the trends we've seen over the past couple of years and will continue to see is an increased flow of sovereign wealth funds into private equity. While not a new trend per se, I expect to see this trend continue to grow. What we've also seen in the industry is larger institutional investors looking to reduce the number of relationships but increase the allocations to their existing relationships in a variety of ways. Many large institutions are looking for a more broad-based strategic relationship with a fund manager, often amounting to an extremely large commitment of capital across perhaps a variety of strategies, thus establishing a strategic relationship that provides for enhanced information flow, enhanced access to co-investments and better fees as well.

Editor: You've mentioned the sovereign wealth funds. Are there new players in that particular area? Some of the Middle Eastern players have been very prominent in the past.

Samman: We are seeing sovereign wealth funds in a variety of jurisdictions – Southeast Asia, Korea, Scandinavia, particularly in real estate – which are building up their private equity programs. The Chinese are quite active. As regulation continues to develop, and outflows of capital become easier, I think we'll continue to see more and more Chinese inflows into private equity.

Editor: Do you expect to see more funds going offshore as a result of the prospective new tax policies?

Samman: It is hard to envision a U.S.-based fund manager of substantial size and reputation moving to an offshore jurisdiction. How such a U.S.-based fund manager could effectively set up an offshore operation and avoid or mitigate taxes while retaining a level of attractiveness for institutional investors such as state pension funds is difficult to imagine.

Editor: With the new registration and filing requirements mandated for funds by Dodd-Frank, do you see the SEC and CFTC playing a larger role in fund governance?

Samman: Absolutely. They already are, and it has changed the way managers are doing business, producing a major culture shift. Our clients have all been compliance-minded and have had programs very similar to the ones that the SEC now requires them to impose as registered investment advisors. The key difference, however, is they weren't operating in a regulated environment, having someone coming in on a regular basis inspecting their operations, nor were they exposed to a specific and codified regulatory regime. This new environment changes the way a manager does business and its culture, a change I think we shall continue to see over time. Private equity is still a bit of a square peg in a round hole. The SEC and CFTC regs and guidelines were not designed with private equity in mind, making it more difficult to advise our clients on how the rules apply to them since their rules and guidelines are not written with their operations and activities in mind. We hope that as the SEC and CFTC become better acquainted with the private equity industry, they will adapt their rules and provide guidance on how they apply to take into account industry practices.

Editor: The U.S. corporate tax rate on corporations is among the highest of all nations. Do you foresee any changes in terms of lowering the corporate tax rates while at the same time taxes on the top earners are raised?

Leonard: The issue of the top rate on individuals is being actively discussed in the current fiscal cliff negotiations. The issue of the top corporate rate, currently 35 percent, could be lowered as part of the tax reform effort, assuming that tax reform as a legislative matter gets traction next year. In this year of 2012, the chairmen of both tax-writing committees have held a series of hearings in anticipation of actual legislation next year. In the course of those hearings, both chairmen have received testimony supporting a substantial reduction in the corporate rate to 25 percent. The political and substantive difficulty with reducing rates to that level is the fact that tax reform, if it advances, will be pursued on what is referred to as a "revenue neutral basis," where rates are lowered and the tax base is broadened in a way that does not increase the federal deficit. In this context, each one percentage point reduction in the corporate tax rate reduces federal revenues by over $100 billion. Thus, within the discipline of revenue neutral-

ity, a 10 percentage point reduction in the corporate tax rate becomes very difficult and very controversial because many of the base broadeners will have political supporters and defenders. The challenge of tax reform will be balancing those competing interests.

Edit: With interest rates at record lows and expected to remain low through next year, how do you expect private equity M&A activity to change in 2013?

Weinstein: We should see increased LBO activity if banks are willing to lend. Currently, there is money available both from banks as well as other fixed income investors, even at the low rates. There is money chasing non-investment-grade yields. Besides increased LBO activity, there should also be borrowings by corporations for refinancings. Currently, corporations are in better shape in terms of current maturities of outstanding debt, as compared to the refinancing activity during the downturn. With a low interest rate environment, companies will employ increased leverage. Offsetting any change in the benefits of that leverage may be any change in the corporate tax rate. Again, these PE shops are always looking to employ leverage to enhance their return, but it comes down to the availability of the low interest rate capital. An interesting question will be whether you will be able to finance a low interest rate loan on a longer-term basis to facilitate leveraged buy-outs and what that term will be.

Editor: Do you expect the private equity M&A activity to accelerate in 2013?

Weinstein: I think you will see it accelerate because interest rates will be lower, capital will be available and the pricing expectations of buyers and sellers will increasingly converge. There will be an increase in deal activity, more with private transactions. We are at a low point right now in M&A activity. With a recovering environment and increasing stock market prices, there will be increased activity, especially strategic divestitures by companies seeking to reallocate capital to core businesses.

Editor: In which industries do you expect to see increased activity?

Weinstein: The energy industry is one where there is much activity in the United States, where you'll see increased investment put to work. Obviously, it depends on the U.S.'s ability to export natural gas. Chemicals, especially chemicals driven off of energy, should see a substantial increase in activity. Health care is another industry that is in transition right now. Financial services is another area where M&A activity is expected, as bank balance sheets are stabilizing, financial institutions' uncertainty is decreasing and cash flow has become more predictable. I think you'll see increased activity in financial services. High tech has already seen increased activity and that will continue.

Editor: Do you see more public companies going private due to increased regulatory burdens?

Weinstein: I see the smaller ones going private because of increased regulatory burdens; disclosure obligations in the public market limit a company's ability to pursue strategic initiatives and take risks. It also depends on the pricing of the stock market. If stocks run up, you'll see fewer take-private transactions. You may also see more strategic combinations when companies use their increased stock prices as currency for an acquisition, which adversely affects the competition in the leveraged buy-out market.

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Editor: Do you see more corporate divestitures in 2013?

Weinstein: There is a lot of demand to buy companies, with large hoards of cash in PE companies waiting to be put to work, thus providing a sizeable market for companies to sell into. This situation allows a company to realign its strategic initiatives, reallocate its capital and focus on and expand its core business.

The expected increased activity for all of these factors will not be to the extent of a bubble. The changes will be evolutionary, not revolutionary.