Private Equity and Venture Capital:
A Roundtable Discussion

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DANIEL AVERY, GOULSTON & STORRS: I'd like to hear from the panel about what they're seeing in their respective areas in terms of hot buttons at target companies. What are becoming big issues when you're looking to invest or acquire or sell a company?

ALEXANDER WEISS, CHARLESBANK CAPITAL PARTNERS: Probably the biggest trend we're seeing right now is that markets continue to be on fire, and the availability of leverage for transactions continues to go up. It's as high as it's been, certainly since the recession, and potentially even before that.

As a result of that, the prices for LBOs continue to come up. The biggest challenge we face every day is how do you find opportunities to buy good businesses at attractive prices?

We're looking for businesses that have stability heading into a recession. It's been a very long period of strong economic growth. And we're thinking about our models, we're thinking, "How do you find a business that performs reasonably well, is fairly non-discretionary, is not something that's going to drop off a lot in a recession?" Because if you're borrowing a lot, and then you hit a downturn, you could have a lot of negative effects from that.

AVERY: Are you seeing particular industries that are of unique interest or disinterest now, and how are you seeing the mix of financial versus strategic competitive bidders when you're looking to buy?

WEISS: Most sectors right now are fairly highly priced. I think there are a couple of exceptions to that. One would be traditional retail businesses, which are trading at much lower lev-

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els, but have major threats from e-commerce. The other sector is energy, [which] has been up and down a lot over the last couple of years with oil prices.

I spend a lot of time working on service businesses, distribution businesses, consumer businesses, and all of those sectors are at historic highs in terms of the multiples we're looking at. As it relates to sponsors and strategics, once you're in the middle of a process it tends to be much more of the sponsors, because it's very difficult for a strategic to be able to compete from a speed standpoint. The trend is that processes are much faster from beginning to end than they were even three, four or five years ago. [From] an initial management meeting to the time when bids are due is maybe a six-, seven-week process, whereas that might have been, 10, 11 weeks before. And bidders need to come with a signable contract in a short period of time in order to be competitive there. In those types of instances, it's usually really difficult for strategics, which generally move more slowly in a transaction context, to be able to make decisions that fast.

AVERY: What's interesting to hear is that the strategic bidders are potentially at a disadvantage because they're not set up internally to move as quickly as the financial sponsors are able to do.

WEISS: We have a number of foreign buyers who are looking to get into the U.S. They typically will hire an investment banker or some sort of M&A advisor who's very familiar working with U.S. private equity firms and then make a preemptive bid in advance of a process to a private equity owned company. If you can do that, then from our standpoint, we're much better able to accommodate a longer timeline or shareholder votes or other things. But if you wait until a business is for sale, that's much more difficult, particularly for non-U.S. buyers who don't have a lot of experience in the U.S.

JULIE MCCANN, BATTERY VENTURES: I'll focus a little bit more on the venture capital side of things. In the VC context, we're still seeing really competitive deals, very high valuations. Everybody just has so much capital out there.

My perspective is a little different because I'm not on the investment team side. I'm just a lawyer who's supporting my internal clients. But from my perspective, valuations are incredibly high. I've had to deal with antitrust analysis in the U.S maybe five or six times this year, which is a sign of the price of things. Maybe in the five years before that, we looked at antitrust analysis just a few times.

So prices are high, things are competitive, and our team needs to stay disciplined, because you still need to have a return that's respectable, even if it's a fantastic company. People are trying to get creative. We're doing a lot of investing in Europe, because I think people generally see that there's a little more value to be had in Europe.

[From] a legal perspective, one thing I think has changed is [that] when it was really competitive, maybe two or three years ago, and the prices were crazy you were seeing one-page term sheets that just said, "Here's a check for $100 million," and really no other terms. [Now] we're seeing terms come back. We're seeing real term sheets and controls and downside protection.

AVERY: In terms of some of the business items, are you seeing the impact of the tariffs and the trade wars with China?

MCCANN: So many of our companies are software companies. They don't make things. The biggest thing has been the immigration policy shift, because so many of our founders are immigrants, and it's so important for the VC ecosystem to have that welcoming environment and not the environment we're in now. Our companies are having trouble encouraging people to come, convincing them that it's not a hostile place, that when they get their family established that they can stay. I think that the resurgence on H-1B Visas, things like that, have really had the most impact [for] the early and ground stage companies.

WEISS: From our standpoint [there are] two things I would highlight in terms of the current administration. One [is] a loosening of regulations around some of the standards on lending and the scrutiny on investment banks in terms of how much they can lend and what types of ratios can be out there. It hasn't had a major shift, but it's definitely moving in the less regulation direction. A second [is] the tariffs. It's definitely company by company, but we have a number of businesses that [are concerned] in terms of how that's going to ripple through.

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Is it going to affect their margin? If all of your end customers are paying more for all kinds of things, does that have an impact on consumer spending?

AVERY: There's been more uncertainty because a lot of the changes that have been implemented by the current administration are by executive order and not by Congress. So a lot of these things could be unwound by a new president easily.

That said, we have been seeing some impact of the tariffs for manufacturing companies. On the immigration front, we've seen a high degree of sensitivity at the founder level, particularly in the tech sector, because of the contribution that immigrants in that area provide.

The other thing we've seen a little bit of is the sense that the federal government may be pulling back in some areas, like environmental. We're seeing states in the U.S. at least make noises that they either will or will not be stepping up to meet that void.

We've definitely seen things around the edges: not cratering deals, yet creating some concerns. I haven't seen it necessarily impact values yet, but there's definitely aspects of diligence and discussion amongst investors and targets that have changed a little bit in the past few years.

AVERY: For a longtime, wage and hour issues were huge, [as were] noncompete issues in California and Silicon Valley. Recently, with the #MeToo movement and the sensitivity around that, what are you seeing?

MCCANN: They're not necessarily shareholder directives, though I know that we have some co-investors where in their standard documents now they say you will have and you will implement and you will comply with anti-harassment policies. It's going into term sheets now. Companies are doing things like that because of the climate and because it's the right thing to do. But I haven't seen anything come up in diligence. I haven't been asked, "Does this company have an anti-harassment policy?" as part of a document request.

WEISS: It's not something that necessarily explicitly shows up in a lot of diligence, but it's something where [we] certainly make sure all of our portfolio companies have tight policies around that, and that we're seeing a diverse pool of candidates when we're doing senior executive searches.

AVERY: Let's talk a bit about some of the things that impact cross border investments and acquisitions from a tax perspective.

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JONATHAN STEIN, GOULSTON & STORRS: We had major tax reform at the beginning of 2018 here in the U.S. Obviously, it's wide-ranging reform, and there's a lot of small things and large things that may or may not affect different taxpayers. When companies invested in the U.S., the most traditional structure was a corporate blocker. The reason why we call it a blocker is because it blocks a lot of U.S. tax obligations by using a corporation as opposed to using a transparent entity.

The blocker would have leverage, so it would be capitalized with both equity and some shareholder debt as well. The reason for that is the U.S. corporate tax rate was 35 percent, which was relatively high relative to other worldwide corporate tax rates in developed economies. And the use of leverage allowed base erosion techniques. So the U.S. income tax base would be reduced because the U.S. company would be able to make these interest deductions.

A similar concept was used with respect to intellectual property where royalties would be paid for related party licenses, and that would also be used to reduce the U.S. tax base and reduce the effective rate of tax to get that 35 percent rate down to a more palatable rate that was more competitive globally.

Those techniques worked well. But on venture capital investments or other smaller investments, people began to invest in the U.S. using more transparent entities, closely held entities. People became more comfortable with limited liability companies and limited partnerships and other types of flow-through entities. Those entities had a few advantages. One of the big advantages — again, this is all under the old regime — is that the rates were a little bit lower. The combined rate on ordinary income and capital gains versus the rates on corporate income plus dividend rate was lower. It also let flow-through of losses. So if you're investing in a startup, and you don't expect it to have real profits until three to five years out, you might want the ability to take advantage of those losses and not have them trapped in the U.S.

But now that we've had U.S. tax reform, I think what we're going to see is a shift back to people using corporate blockers, and that's for a few reasons. One, the base erosion is less important and less attractive. With the U.S. corporate tax rate at 21 percent, it's possible that the home country rate of the investor will be higher. So you're not really gaining anything by moving that income from one jurisdiction to another.

AVERY: By that, you mean that there is less of a tax-related impact from inter-company financing and IP licensing?

STEIN: Yes. [You don't have to] capitalize the company and [have] the need for leverage and the need for related party licensing and things like that.

So, corporate rates are now 21 percent. The individual top rate is 37 percent. Individuals can also potentially benefit and lower that 37 percent rate with a 20 percent deduction. That applies to certain pass through income, and non-resident aliens are eligible for that deduction.

We tend to focus on businesses and scale, but if an individual investor is actually making an investment, they would have to look again to see whether a flow-through is worthwhile, because they might get the benefit in certain industries of this 20 percent deduction. Outside of a really small individual investment like that, I think blockers will be more popular again ... because of the lower rates.

[The other] reason why it's important perhaps to be in a blocker, as opposed to a flow-through, is that there now can be U.S. withholding tax on the sale of the equity of the flow-through. So if you sell an LLC membership interest or if you sell a limited partnership interest from your Delaware limited partnership or your Delaware LLC, when you sell one of those types of flow-through entities, it's treated as if you had sold the underlying assets, and U.S.

withholding tax can apply, whereas when you sell stock, there's generally not any withholding tax.

AVERY: What about repatriation type issues that come out?

STEIN: One of the issues is a one-time repatriation tax that we have now in the U.S. It was very common for companies who had active foreign income to keep that cash offshore and not bring it back to the U.S., and that was because they would pay a tax when they brought it back to the U.S.

With the tax bill, we now have a one-time sort of de-facto repatriation. What that means is all the companies are now treated as if they had brought the cash back, whether or not they did so, and will have to pay taxes on that cash as if they had brought it back.

That could create diligence issues. We're dealing with it now in M&A where we have a U.S. company that has a Canadian subsidiary that is a very traditional company that makes things,

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and they have a lot of cash from their manufacturing in Canada that they kept in Canada and used in Canada. But now, they have to pay U.S. tax on it, and the sellers and the buyers have to allocate that tax liability.

AVERY: Are [you seeing] many deals ... in Europe or China or other [places outside of the] U.S.?

MCCANN: A much higher percentage, relative to the past, of our investments are now in Europe or Israel or recently Australia, which is new for us. And [we're seeing] more U.S. firms. We're seeing them in our syndicates and we're competing for deals against them, where that was probably not the case recently. I met with a lawyer from the UK a few weeks ago, and he was saying the same thing: that they're seeing more U.S. firms either trying to establish a presence there or just trying to invest from their headquarters here.

WEISS: We've always been active in Canada. We're for the most part not doing a lot of dedicated investing in Europe. But a lot of our larger competitors have a dedicated European fund or a dedicated Asian fund and are investing there. And in some cases, they have global funds and look across borders.

MATTHEW EPSTEIN, GOULSTON & STORRS: Is there an industry that is growing right now?

McCANN: I'm going to be biased because we only invest in technology. But there's an expression that software is eating the world. There's a software solution for every problem, and you just need to find the right company that's solving that problem and has the software to do it. I think aside from that, anything related to crypto people are getting interested in.

That's the area that I think will be most interesting to watch, because there are smart people who are saying this is the future, [and] smart people who are saying be careful of this. The regulatory landscape is very unclear at the moment. The government is trying to wrap its head around crypto technology at the same time as investors, and everybody is a little bit behind the people who are working on it. I would say that's probably going to be the biggest game changer.

AVERY: What are you seeing at the lower end of your enterprise values in terms of sectors that are kind of hot or not?

WEISS: Technology and software is affecting more and more businesses. It's not so much a

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sector anymore, but something that kind of goes across everything. On a smaller scale, there's lots of distribution businesses and service businesses that were historically very local on a regional basis that have been in the earlier stages of consolidation. Private equity has spent a lot of capital consolidating distribution and service businesses.

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AVERY: There are very new financial services, like crowdfunding, that are taking over projects more locally. What is the approach that you foresee your firms will have?

MCCANN: I think that we will see regulation. I don't think this is an area that is going to be deregulated. The SEC is trying to be cooperative with the people who are creating these technologies and investing in these technologies so that they don't stifle all this innovation, but they've been pretty clear that you're going to need to be in the realm of securities laws.

STEIN: With respect to crypto currency and Bitcoin, if the SEC is behind, the IRS is even further behind, and there actually is a piece of tax reform that's relevant to this. The IRS's view is that crypto currency is property, not currency under the tax law, and so all the special rules that apply to currency traders don't apply to crypto traders.

You [will] see change with respect to the cannabis industry. The banking issues have not been solved. The tax issues have not been solved. It's still a Class 1 substance federally, which means that you can't have any normal trade or business deductions, so they're effectively taxed on their gross sales from inventory. They can only exclude cost of goods sold, not other expenses.

AVERY: A lot of the deregulation we're seeing in the U.S. has been an attempt to pull back or dismantle large existing bureaucratic institutions. I don't necessarily think that's going to mean that new risks or consumer risks won't be regulated.

AVERY: Bubbles can burst. I think memories are short. In 2008 and 2009, we said it would never happen again. Julie, how do you see Battery looking out toward the future in the context of technology bubbles?

MCCANN: I'm sure every investor says this, but that's why you try to be uniquely disciplined

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on the way in and just not invest in the companies that you think are just benefitting from a bubble, even if you love the company, because you can see down the road that part of the return analysis is, even if things go awry, could we at least get our money back at this valuation. I think you just become a very long-term investor.

WEISS: From a micro standpoint in terms [of what] we think about underwriting our investments, we'll typically assume if we're buying something for 10 times today, we assume that we're going to sell it for nine times in the future, all else [being] equal, just because we have some inflation in where we are, and I think a lot of that comes to the leverage markets.

It's easier to get cheap debt today than it has been really at any other time in history, and that's not going to be available over a long sustainable period of time. So even if the fundamental business is the same, if you're borrowing six times versus seven times, that's going to affect the multiple. That's how we think about it on an underwriting basis, but I think from a broader economy standpoint, you certainly are seeing short memories [about] a lot of things. You're definitely not seeing a lot of caution like you would have five years ago.

EPSTEIN: If foreign clients would like to be in the best position to seek American private equity, are there things that they can do so that the private equity firms' brains won't explode when they do due diligence?

WEISS: Having a local buy side advisor is often very helpful, [someone] who's just very familiar with what our expectations would be in the market, and so they can often be very helpful in facilitating that process.

From our standpoint, we are often much more open to entertaining a potential buyer of one of our businesses. If it's outside of a process, you have a clear timeline of what it's going to look like you get. A typical process would be you might get a little bit of information, a company evaluates it, and then once you agree on a price and an LOI, you've got something like 30

days to go and do the work, and you'll have kind of unfettered exclusive access to the company during that period. And if you have a very high conviction that the transaction is going to get done, then our interest in pursuing that is much higher. If it feels like it's more of a fishing expedition, then we would try to suss that out earlier.

Often, you can tell based on who are the advisors that they've engaged. Are they spending money on legal and accounting? Are they asking the types of questions that suggest they know the business, they know what they're getting into? If they kind of come in and say, "We want to get into the U.S. market in some capacity. We're not sure how. Tell us about your business," that's much less exciting.

If they say, "We know you guys, and we've been looking at targets for a while, and we think you're the right target, and here's why and let us kind of go through and make sure that your books are clean," that case is the one where you have much higher odds of kind of getting access to the company to be able to do that.

MCCANN: If you're talking about taking U.S. money for an investment or an acquisition, I think from our perspective we try to adapt to the local norm. So we wouldn't come in and be the big U.S. fund with our exact formal purchase agreement and U.S. terms and expect to see the diligence look exactly how it would for the most buttoned-up U.S. company.

We would hire somebody local who would talk to you as local counsel and be able to identify whether things look good, whether they're using good forms of employment agreements, whether their leases are fine, whether they have a bunch of customer contracts with crazy indemnification terms. But we'd really rely on local counsel to translate and say this might look messy to you as a U.S. person [but] here, this is pretty common for a company this size. Or [conversely,] this looks pretty messy, it looks like their CFO did everything [and] they never used outside counsel until they were trying to get an investment or trying to get sold. [Or] this lawyer is good, but they haven't been there along the way.

It's sort of the same as in any deal, except that you're using local counsel to say things look pretty good or this is going to be a haul to try to get due diligence. RILW