Cherry Bekaert
Your Guide Forward

How is private equity responding to prevailing economic headwinds?

Following a record year for the industry in 2021, Cherry Bekaert's transaction advisory team offers insights

By all accounts, 2021 was a record year for private equity M&A, and through Q1 2022, deal activity has remained strong. However, variables such as inflation, supply chain delays, labor market constraints, and rising interest rates suggest there may be challenges on the M&A horizon. Cherry Bekaert's Sidney Glick and Al Sanifar provide insights on the evolving landscape.

What has been the effect of increasing inflation on deal activity, and how are sponsors responding?

Inflationary pressure inevitably causes margin compression and creates business trends toward cash preservation. Our current inflationary environment is at its highest point in 40 years and is also coupled with an unprecedented challenge around talent attraction and retention, marked by labor shortages and higher labor costs. There are also ongoing issues within the global supply chain driven by plant shutdowns, higher fuel and freight costs, and increasing commodity prices. While many companies have increased sales prices, the increases have not yet offset the higher cost model, which is leading to further margin compression and cash constraints.

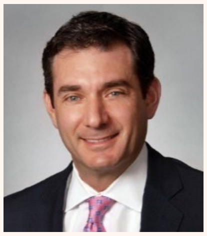
Sponsors are responding in several ways. First, the due-diligence evaluation process is moving away from what has historically been a heavily focused, rear-view-mirror approach to one with greater emphasis on forward-looking views on business and operational risks. A better understanding of vendor contracts, supplier diversity, volume commitments, and the ability to pass cost increases on to customers is helping sponsors develop models and plans that can be quickly altered in response to rapidly evolving market uncertainties. Forward-looking strategies are being applied not just to acquisition targets, but also to existing portfolio companies.

From a tax perspective, we are also seeing the return of a last-in, first-out (LIFO) inventory election as a tax planning tool. As the time value of money (TVM) concept has returned as a consideration, this long-proven mechanism to reduce tax consequences in periods of inflation through LIFO elections provides a preservation of cash, which can be used for needs other than income taxes.

Despite these challenges, PE's access to abundant levels of dry powder continues to propel M&A markets. While margin compression hasn't materially impacted valuations yet, sponsors continue to monitor this risk closely. Should public market valuations continue to decline, or if we enter a recessionary period as some are forecasting, valuation expectation gaps will likely emerge. For now, however, multiples remain elevated in relation to historic levels.

You mentioned some unique challenges being encountered in the due-diligence process. Would you expand on those?

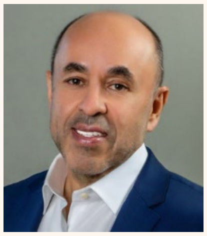
Investors are interested in understanding and isolating the earnings impact on target companies and how management teams are responding. Given the current environment, it is imperative for sponsors to determine a normalized level of EBITDA



Sidney Glick

Principal, Deal Advisory Services
Cherry Bekaert

Sidney has over 20 years of due diligence, finance and accounting experience, advising on M&A, financial diligence, and valuation engagements across numerous industries, including healthcare, technology, industrial and financial services. Sidney works closely with private equity funds, senior and mezzanine lenders, and strategic firms in all aspects of acquisitions and divestures.



Al Sanifar, CPA

Partner, Private Equity Tax Services Leader
Cherry Bekaert

As the Tax Services Leader of the Firm's Private Equity Practice, Al provides guidance to numerous private equity firms on tax planning and reporting at both the fund and the portfolio company levels. He has more than 25 years of tax experience serving private equity, venture capital, family offices and other alternative investment funds on transaction tax activities, including transaction structuring and tax due diligence.

As previously published by PitchBook on June 16, 2022 - https://pitchbook.com/news/reports/q1-2022-us-pe-middle-market-report

during due diligence by considering prospective operational impacts to the business, finance, and accounting functions.

Examples include: (a) labor constraints: Employee turnover trends and reasons for turnover; whether existing salaries reflect current market levels; changes to the onboarding and training program (and costs) for new employees to minimize inefficiencies associated with transitions; outsource versus insource hiring decisions; temporary and seasonal hire considerations; and increased employee retention costs (retention bonuses, improved benefits, etc.); (b) supply chain: Price increase notification that may not be reflected in the trailing twelve months (TTM) or projections; assessment of whether viable alternative suppliers exist; alternative freight options; demurrage trends; price-protection mechanisms in vendor contracts, etc.; and (c) customer pricing: Contract terms, particularly whether customer contracts include CPI protection; ability to pass on price increases, especially to significant customers; surcharges for fuel/commodity expenses, foreign currency gains/loss and hedges, etc.

How is the rising interest rate environment impacting M&A?

While we have not yet seen an adverse impact on deal activity, rates are certainly top of mind. Rising interest rates can adversely affect valuations of existing holdings, as well as the ability to finance new acquisitions. Since the aftermath of the global financial crisis (GFC) in 2008 and 2009, the PE industry has matured, and most believe the industry is better prepared to face any potential economic downturn. Nevertheless, skepticism as to how long the low-rate environment can last has resulted in firms proactively pushing out maturities where possible, managing cash flows, and structuring covenants with a margin of safety. Operationally, portfolio companies are sharpening their pencils when budgeting and planning debt-related expenses in the near term.

Buyers are also beginning to realize that the combination of rising interest rates and the 2022 change in calculation of the limitation on business interest deductions can be expensive. Interest deductions are limited to 30% of adjusted taxable income (ATI). For tax years beginning in 2022 and beyond, depreciation, amortization, and depletion deductions will no longer be added back in calculating ATI, which will reduce the interest expense deduction limit for companies with depreciation deductions.

This means that for many taxpayers, just as interest rates are going up, the portion that can be deducted is going down. For transaction planning purposes, this requires a complicated analysis of the interaction between interest and depreciation or amortization deductions in optimizing acquisition capital structures. Ultimately, this analysis may begin to affect either pricing or structuring preferences.

Fear of changes in tax rules contributed to 2021 M&A activities. What are the current "hot" tax issues in the market?

State taxation is probably the most rapidly developing area for transactional tax risk. States are aggressively looking for "contacts" that give them jurisdiction for tax purposes. If the economy adversely impacts a state's revenue base, history shows taxing authorities will become even more aggressive in their enforcement activities.

States are finding taxable contacts, such as presence of workers, including remote workers, and inventory held in online sales platforms' warehouses, even if the platforms move the property from state to state regardless of the owners' preferences. In addition, they are structuring their tax laws to get around limitations imposed by federal law. In the area of sales taxes, some states are placing various services, often including software-as-a-service (SaaS), within the scope of taxable transactions. States are intensifying their efforts to find reachable taxpayers through tactics such as requiring online platforms to report the location of inventory storage.

There is also a general misconception that "pass-through" entities such as partnerships and S-corporations, which are not taxable for federal income tax purposes, are also not taxable for state income tax purposes. That is often untrue, as states have been implementing collection mechanisms that place financial responsibility on businesses to ensure that their owners' state taxes are paid. If disregarded, those collection mechanisms create direct tax risks for entities that would otherwise be pass-through entities.

Could transactional tax strategies help create value for sponsors during a time of uncertainty?

In addition to some of the cash preservation strategies we've discussed, complexities and constantly changing regulations provide for tax planning opportunities in every aspect of the transaction lifecycle, despite economic headwinds. During the acquisition phase, sponsors can utilize structures that can maximize tax benefits from the onset. During the holding period, there are further opportunities to accelerate tax benefits through optimization of tax planning, which requires a thoughtful analysis of structuring options and alternatives that drive growth and promote value. Upon exit, structuring a tax-efficient sale can be vitally important to minimize capital gains tax. These strategies can be designed to help sponsors realize maximum returns regardless of the economic cycle.

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