January 26, 2016

No exit for financial sponsors?

A shuttering IPO window threatens private equity returns—if only by casting doubt on valuations

BY BOB O'BRIEN

Volatility in stocks is withering the market for initial public offerings. As one of the viable options that private equity firms have for monetizing assets they're attempting to sell, the devastation to the IPO market seems like a significant overhang constraining the exit activity of PE firms.

"The new year hasn't started very well in terms of the public market's performance," Aamir Husain, who heads the U.S. IPO readiness practice at **KPMG LLC**, said in what amounts to an understatement. (Husain was interviewed when the S&P 500 was off slightly more than 5%, rather than the 9% plunge it recently recorded.) "And the issues that characterized the last quarter of 2015 will linger on through at least the first quarter of 2016, which will have an impact on new issuances in the IPO market."

AP

But a diminished IPO market isn't a sword of Damocles for financial sponsors, even those looking to maintain the feverish pace of exit activity that has characterized the PE business the past two years. Far from being a reason for PE managers to reach for the Xanax, financial sponsors are being challenged to find alternatives to capitalizing assets via public issuances. Or, in some cases, acknowledging that IPOs—once one of the favorite arrows in the PE market's quiver—have been greatly diminished in importance.

"Granted, private equity firms won't want to bring an IPO to a market that's experiencing this kind of volatility," said James Cassel, co-founder of the investment banking firm, **Cassel Salpeter & Co.** in Miami. "But what you have to realize is that, for PE firms, an IPO is a strategy that allows them to show what an asset is worth."

The point, many experts insist, is that filing for an IPO amounts more to a flirtation than to a committed relationship. Financial sponsors use the process, and the plethora of data included in documents, as a way to test how others evaluate the asset.

The argument is that IPOs, as an exit strategy, have lost a good measure of relevance. Case in point: for all of 2015, the number of PE-sponsored assets brought public via an IPO worth over $1 billion amounted to a grand total of ... one. **Kohlberg Kravis Roberts & Co. LP** brought **First Data Corp.** (FDC) public, raising $2.6 billion.

Truth is, the number of PE-sponsored IPOs fell dramatically in 2015, when just 39 PE-sponsored companies filed to go public, versus 71 in 2014. The dropoff in dollar values was also quite appreciable, with $11.5 billion raised in PE-sponsored IPOs last year, versus $25 billion the prior year, according to research from **Renaissance Capital LLC**, a global IPO investment adviser providing institutional research, investment management and indexing services.

But the flipside to that downfall is that other major assets that were buffed and shined in preparation for their public debut, including **Petco Holdings Inc.**, **PharMEDium Healthcare Holdings Inc.** and **SunGard**, ultimately went to buyers—to another PE sponsor in the case of Petco, to strategics for the other two. Alas, in many cases, filing for an IPO is an exercise in letting potential buyers get a peek under the curtain at an asset's underlying fundamentals.

None of this is meant to be Pollyannaish. "Any time you see volatility in a equities market, it puts stress and strain on anybody with IPO plans," said Wayne Pinnell, managing partner at **Haskell & White**, which is the largest independently owned accounting, auditing and tax consulting firms in Southern California.

The IPO market, in many ways, amplifies the conditions in other markets, whether it involves stocks, commodities or high-yield bonds. At the moment, the IPO market looks as robust as a National

CONTINUED >

TOP STORY

< PREVIOUS

Basketball Association center playing the fourth overtime period of the game.

"The heightened volatility of the last 12 months makes the weakness in the IPO market more pronounced," said Keith Trammell, partner at **Hogan Lovells** in Washington. "In the middle market, especially, where our practice if focused, you haven't seen IPOs provide enough price support to provide an exit path."

The overall IPO market already was in decline in 2015. Perhaps that's not a complete surprise, given that the preceding year proved to be a record breaker. Though the actual number of deals slipped just 2%, to 1,218 last year, the dollar value of those deals tumbled 25%, to $195.5 billion, according to data from the EY Global IPO Trends report. (Even taking out the record-setting proceeds of the 2014 IPO of **Alibaba Group Holding Ltd.** (BABA), 2015 global IPO proceeds fell off 17% versus the prior year, when a record $244 billion was raised in the global IPO market, according to the EY report.

Last year, 27 assets owned by private equity sponsors that filed all the documentation needed to go public, theoretically wanted to raise an estimated $4.5 billion, but in the end, these PE-backed companies put the kibosh on their IPO ambitions, according to data from Dealogic.

Some 219 PE- or venture-backed companies filed for IPOs in 2015, or 18% of the entire IPO pool, according to the EY report. But more than 20% of the PE-sponsored IPOs got pulled, the most since 2012, when 34 PE-backed companies decided not to execute their plan to go public. (And, of course, there's no way to know how many companies that had filed secret preliminary registration documents abandoned their IPO ambitions.)

While most of the IPOs that were canceled or postponed involved middle-market or lower valuation companies, the roster included a few notables: **Albertsons Cos.** (backed by **Cerberus Capital Management LP**), **Neiman Marcus** (backed by **Ares Management LP** and the **CPP Investment Board**) and **Univision Communications Inc.**, the Spanish-language television company held by a consortium including **Madison Dearborn Funds**, **Providence Equity Funds**, **TPG Capital**, **Thomas H. Lee** and **Saban Capital Group**. (Univision has indicated that it plans to reignite its IPO ambitions.)

According to Renaissance Capital, seven large leveraged buyouts that prepared to raise about $7 billion in the fourth quarter of last year through IPOs have pushed out their IPO ambitions.

"So far in 2016, equity market conditions have deteriorated," said Kathleen Smith, principal at Renaissance Capital, where she manages the firm's IPO-focused exchange-traded funds that trade under the symbols IPO and IPOS. Smith's argument isn't that the enervation of the IPO market isn't without consequences for PE firms. For one thing, the appetite of the market to absorb the stock issued by companies sponsored by PE firms might be compromised. Market conditions "will make IPO investors much more price sensitive, if not hostile, to highly leveraged companies facing anemic growth," she said.

That, of course, would seemingly presume that PE sponsors are trying to bring virtual cadavers to the public-issue market. And if there's one thing a withered IPO market is going to govern against, it's going to be low-quality assets. Companies that actually succeed in getting to the IPO market are going to be essentially squeezing through a pretty narrow pipeline, and they're going to have to be robust enough to do so. There are exceptions, of course. The pipeline for biopharma IPOs, for example, is very healthy. See Private Briefing, page 6. Meanwhile, the volatility in capital markets isn't limited to stocks, let alone to IPOs. "With credit spreads rising, the pressure on PE funds to re-equitize leveraged balance sheets will rise," Smith added.

"As a result, we expect to see private equity IPOs move forward, but IPO discounts will be high for the deals that actually get done," Smith said.

That discounting will present the touchy moment for PE firms. "Financial sponsors are not willing to compromise on valuations," said KPMG's Husain.

What's been proven recently—witness what happened to **Square Inc.** (SQ), whose private market value in its last round of fundraising appraised the company at $6 billion but whose IPO number was $3.9 billion—is that private market valuations are often much more generous than what's

CONTINUED >

< PREVIOUS

seen in the public markets.

That disconnect is an especially pronounced problem for private equity-owned assets being groomed for an IPO, since financial sponsors typically sell only a portion of their stakes in the debut, anticipating the payday down the road when lock-ups expire and they can execute secondary sales.

But if there's a gulf between where those owners were carrying an asset on their books—PE firms use mark-to-market accounting quarterly—and where the public market assesses their value, there's, at the very least, a risk that it could take a long time before public values catch up with the former private values. Remember that in its third quarter, **Blackstone Group LP** (BX) ended up recording a loss for the period, largely due to the public market's mid-summer swoon diminishing the value of the shares of companies the New York PE firm had taken public but still had stakes in.

So, what, then, are the alternatives for financial sponsors who were considering monetizing an asset via the IPO market? Especially those firms still hanging onto assets bought with 2007 or older vintage funds, which are the kind of ripe investments for whom the exit clock ticks loudest.

"Asset holders want to, are good at, maximizing their optionality," said Jackie Kelley, EY Americas' IPO practice leader.

One strategy might be old-fashioned patience. "When volatility comes down," she added, "there's certainly going to be no shortage of interest in pursuing IPOs."

Meanwhile, rules changes installed by the JOBS Act loosened some of the registration requirements that companies contemplating an IPO had to follow, shortening time frames and, essentially, allowing those companies to file non-public registration documents. Certainly, these companies will eventually have to file public documents, which is what many companies have already done. As a result, there will plenty of candidates who can jump into IPO line if market conditions reverse.

"As you review history, there have been times when the IPO market suddenly opens," Cassell said. "We could have this volatility for the next month or more, and then all of a sudden that window opens, and all of these companies that have quietly filed are ready to jump."

The IPO alternative has always been just one of the legs of the stool on which PE exits stand, and, it could be argued, the least sturdy of the bunch. The go-to route has always been the sale to a strategic buyer.

"There's strategic buyers out there that have been growing their balance sheets," Hogan's Trammell said. "The availability of cheap debt allows them to continue to be acquisitive, and I'd expect that to continue in the future."

Added KPMG's Husain, "Any private equity fund, whether it's a bulge-bracket firm or a middle-market operator, would rather pursue M&A than an IPO, under any circumstances."

Why? Because by the time a PE firm unwinds a position via a public offering, two years or more may have elapsed. And while the firm has been carrying the asset on its books, that's not a liquid asset that could be distributed to investors, as is the case with a sale to a strategic buyer.

And, of course, there's always the sponsor-to-sponsor transaction opportunity. Last year, for example, there were $42 billion worth of secondary buyouts, a 300% increase from five years ago, according to research from Prequin. Despite the upheaval in the public markets, there's a record level of dry powder—some $416 billion, according to Preqin—on the books of private equity firms, which, by its nature, carries the impetus to put that capital to work.

"The nature of the PE business has been changing," Trammell said. "We're seeing LPs demanding direct investments, the entrance of sovereign wealth funds, and PE funds that are more open to minority investment partners. So they're being challenged to think about capital deployment in more ways than they did in the past."

At the end of the day, while the IPO market may have occasionally functioned as a place for PE firms to off-load some assets that weren't their most-prized investments, the disruption of the IPO market doesn't shut the door on the gaudier of assets.

"For the right company with the right story," said Brandon Parris, co-chair of **Morrison & Foerster LLP**'s Global Corporate Department, "there's always a market out there." ■