Session 302: Private Equity-Backed IPOs & Venture Capital Space – What We Have Seen Recently and Where Things Are Going

The number of companies being taken private-by-private equity firms is once again on the rise and private equity-backed initial public offerings (IPOs) continue to be a significant driver of IPOs and activity in the capital markets. This panel will explore critical issues facing companies both at the time when taken private by private equity firms and at the time of an IPO exit, including increasing regulatory scrutiny of takeovers and exits of regulated businesses, and discuss structuring matters, including “up-C” and other structures. Venture capital has been a catalyst for innovation, a driver of economic activity and the source of seed capital for some of the world’s best-known companies. It is also a space that is constantly evolving. The panelists will review trends and new developments in PE-backed IPOs, including corporate governance rights, and the venture capital space with a focus on what in-house and outside counsel need to know to facilitate their interactions with, and better serve, their companies and clients.

Program Chair & Moderator:
Dwight Yoo, Partner, Skadden, Arps, Slate, Meagher & Flom LLP

Speakers:
Benjamin A. Aronovitch, Deputy General Counsel, Taylor Morrison Home Corporation
Clinton Foy, General Partner and Managing Director, CrossCut Ventures
Lawrence G. Wee, Partner, Paul, Weiss, Rifkind, Wharton & Garrison LLP
Private Equity-Backed IPOs & Venture Capital Space

What We Have Seen Recently and Where Things Are Going

Dwight Yoo (moderator)
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November 7, 2014

Trends – Private Equity
Trends – Private Equity

- Number of deals
- Capital invested / size
- Valuations
  - “Bidding wars”
- Industry
  - Regulated industries
- Region
- Fundraising

Private Equity Exits

PE exits by IPO through the first three quarters of 2014 have been strong and full year 2014 is on track to be one of the strongest in over a decade.*

* Source: PitchBook (in USD billions).
PE Sponsors & Director Nominations

Approximately 72% of PE Sponsors retained rights to nominate directors Post-IPO. Most PE Sponsors retained rights to designate Board members with less than 20% ownership of stock.

- Independent of Stock Ownership: 69%
- 50%+ Stock Ownership: 12%
- 20-50% Stock Ownership: 16%
- <20% Stock Ownership: 3%

Action By Written Consent

Most companies permit PE Sponsors to act by written consent but prohibit stockholder action by written consent when Sponsor holdings drop below a specified threshold.

Example:

At any time when Blackstone beneficially owns, in the aggregate, at least 40% in voting power of the stock of the Corporation...any action required or permitted to be taken at any annual or special meeting of stockholders of the Corporation may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting forth the action so taken, shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted...At any time when Blackstone beneficially owns, in the aggregate, less than 40% in voting power of the stock of the Corporation...any action required or permitted to be taken by the stockholders of the Corporation must be effected at a duly called annual or special meeting of such holders and may not be effected by any consent in writing by such holders;

Amended and Restated Certificate of Incorporation of Pinnacle Foods Inc.

* Note: Includes (1) a company where action by written consent is dependent upon non-Sponsor stockholdings and (2) a company where action by written consent is dependent on whether a secondary class of stock remains outstanding.
Approximately 77% of companies provided for a classified board of directors.

Classified Board of Directors

- 77% Classified board
- 23% No classified board

Trends – Venture Capital
Overview

- Number of financings
- Size of financings
- Valuations
- Burn rates
- Exit flow
- Fundraising
- Is this a bubble?

Digi-Capital Mobile Internet Trade Exits & IPOs (LTM $B)
Companies are raising larger amounts of capital before going public

Median amount raised prior to IPO ($M)

Source: Dow Jones Venture Source 2014 via EY
Why 2014 is different than 2000

- 50 times MORE Internet users in 2014 than in 2000.
- 2.5 billion internet and mobile users in 2014 vs 50M in 1995.
- 120X faster online broadband and wifi speeds vs. 56k modems.
- Mobile changes everything. 2 billion touchscreen mobile phones vs zero in 2000.
- Social changes everything. 2 billion active users on FB, twitter, instagram, snapchat sharing everything.
- E-commerce has exploded. 1 billion digital shoppers with $1.5 trillion spent in ecommerce and growing in 2014.
Up-C Structure

Typical Pre-IPO Operating Partnership Structure

- PE Sponsors
  - Partnership Units

- Management Team
  - Profit Interests

- Other Investors
  - Partnership Units
  - Guarantor of Debt

- Holdco
  - (Pass-through treatment for tax purposes)

- Operating Partnership
  - Credit Facility and Bonds


**UP-C IPO Structure**

- All partnership interests in Holdco are converted into non-voting common units based on IPO valuation and assumed liquidation of Holdco. Each pre-IPO member of Holdco is issued a number of shares of Class B common stock equal to the number of non-voting common units it holds. Members can exchange one non-voting common unit and one share of Class B common stock for one share of Class A common stock.

- Newly-formed C corporation (Pubco) becomes the managing member and uses IPO proceeds to purchase non-voting common units from Holdco or its members.

**UP-C IPO Structure: Advantages and Disadvantages**

**Pros:**
- Income of Holdco attributable to pre-IPO investors is not subject to corporate tax.
- Exchange mechanism provides liquidity to pre-IPO investors.
- Pubco (the IPO vehicle) receives a step-up in basis upon pre-IPO investors’ exchanges of LLC units and Pubco Class B shares for Pubco Class A shares, which could create goodwill amortization and other depreciation deductions that may reduce the taxable income of Pubco.
  - Typically, 85% of the cash tax benefit of the step-up is paid to the pre-IPO investors (not the public shareholders) under a **tax receivable agreement** (a “TRA”) among Pubco and the pre-IPO investors. 15% of the benefit is retained by Pubco.
  - TRAs are based on the notion that the public markets may not adequately value tax attributes.

**Cons:**
- The UP-C structure is complex and expensive to implement and maintain
- The post-IPO treatment of existing pre-IPO management equity can be complex.
- However, the UP-C structure has become increasingly common in the marketplace and is now widely accepted. Also, the tax benefits and tax receivable payments typically outweigh the costs of the structure.
**Issues For UP-C IPO Structures in Credit Agreements and Indentures — Change Of Control**

- **“Change of Control” issues in Credit Agreements:**
  - Is the IPO by Pubco a Qualified Public Offering?
  - Pubco may not own a majority of interests in Holdco.
  - Is Pubco a Permitted Holder?
  - Pubco may not be controlled by the Sponsors.

- **“Change of Control” issues in Indentures:**
  - Is Pubco a Permitted Holder?

- **Preparation tip:** If you think there may be an UP-C IPO, negotiate your Change of Control definitions to disregard intermediate holding companies and “look through” to the ultimate beneficial owners. This is particularly important for debt securities, which are difficult to modify through a consent process.

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**Issues for UP-C IPO Structures in Credit Agreements and Indentures — Affiliate Transactions and Restricted Payments Covenants**

- Is the Reorganization permitted under the Affiliate Transactions covenant?
- If the TRA is entered into by Holdco or Operating Partnership, is it permitted?
- Bank/Bond covenants typically won’t apply to Pubco. Movement of money, however, up to Pubco in order to facilitate payments under the TRA or to fund the payment of dividends by Pubco is most likely restricted by the Restricted Payment covenants.

- **Preparation tip:** Pay attention to structuring and tax distribution provisions in the constituent documents of Holdco and Operating Partnership prior to the time Holdco or Operating Partnership initially incurs debt (particularly debt securities, which are tough to amend). If an UP-C IPO is a possibility, build appropriate tax distribution provisions into the constituent documents of Holdco and the Operating Partnership so that such provisions get “grandfathered” into the exceptions to the Affiliate Transactions and Restricted Payments covenants. Otherwise, you will need to verify if there is sufficient room under the Restricted Payments covenant.
Issues for UP-C IPO Structures in Credit Agreements and Indentures — Reporting Covenants

- Is Holdco obligated to provide annual and quarterly financial statements?
- Unless there is some form of relief in debt instruments, Pubco and Holdco will both need to provide financial statements.
- **Preparation tip:** Make sure the reporting covenants work for an UP-C. Standard language would allow Pubco reports to satisfy the Holdco reporting requirements so long as any material differences are highlighted for the readers. Same thing goes for an earnings call requirement in a 144A-for-life high-yield indenture.

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Issues for UP-C IPO Structures in Credit Agreements and Indentures — Other Covenants

- High-yield bond covenants will typically allow redemption of a percentage (usually 35-40%) of the bonds originally issued using the proceeds of an equity offering (an “equity claw”). Make sure the equity claw can be used if the offering occurs at Pubco and the proceeds are contributed to Holdco and the Operating Partnership.
- The amendment of Holdco’s governing documents may be restricted by the Credit Agreement.
Taylor Morrison Home Corporation

- One of the largest homebuilders in North America, with operations in Florida, Texas, Colorado, Arizona, California and Canada.
- A land developer and builder of lifestyle communities, including single-family detached and attached homes serving a wide array of customers, from first-time buyers and move-up families to luxury and “active adult” customers.
- Operates as Taylor Morrison and Darling Homes in the United States and as Monarch in Canada.
- Monarch is Canada’s oldest homebuilder. It builds homes for first-time buyers and move-up families in Toronto and Ottawa as well as high rise condominiums in Toronto.
- Over 5,800 closings and $2.3 billion in total revenues in 2013.
- Headquartered in Scottsdale, AZ.

The Sponsors and the IPO

- The Sponsors
  - TPG Global, LLC
  - Oaktree Capital Management, L.P.
  - JH Investments Inc.
- The Offering
  - Initial public offering of 23,810,000 shares of Class A common stock priced at $22.00 per share (top of the $20.00-$22.00 offering range).
  - Upsized to 28,572,000 shares in response to market interest (full 20% increase).
  - 32,857,800 shares after underwriters exercised over-allotment option (greenshoe) in full.
  - Total offering size of $723 million, giving Taylor Morrison an initial market cap of $2.7 billion.
**Transaction Timeline**

- Major events in course of IPO:

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>November 6, 2012</td>
<td>Kickoff meeting with Working Group</td>
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<tr>
<td>December 5, 2012</td>
<td>Initial filing of S-1 Registration Statement</td>
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<tr>
<td>January 16, 2013</td>
<td>SEC comments received December 31, 2012</td>
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<tr>
<td>February 13, 2013</td>
<td>First S-1 amendment filed</td>
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<tr>
<td>February 26, 2013</td>
<td>SEC comments received February 26, 2013</td>
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<tr>
<td>March 6, 2013</td>
<td>Second S-1 amendment filed</td>
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<tr>
<td>March 18, 2013</td>
<td>SEC comments received March 18, 2013</td>
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<tr>
<td>April 1, 2013</td>
<td>Various confidential submissions regarding price range and other matters</td>
</tr>
<tr>
<td>April 1, 2013</td>
<td>“Red herring” filed April 1, 2013</td>
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<tr>
<td>April 8, 2013</td>
<td>Fifth S-1 amendment filed April 8, 2013</td>
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<tr>
<td>April 9, 2013</td>
<td>Pricing and final prospectus filed April 9, 2013</td>
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**Structuring**

- Pre-IPO Structure:
Structuring (continued)

• Final Post-IPO Structure:

After the UP-C IPO: Practical Tips for In-House Attorneys

• Expect questions from the SEC
  – Even after clearing the hurdle of IPO review, expect the SEC to continue to follow-up on the legal and accounting implications of the structure in reviews of Exchange Act reports.

• Expect questions from investors
  – Despite prevalence of Up-C’s among certain issuers (e.g., REITs), non-specialized investors may need additional explanation with respect to ownership calculations and attribution of income (non-controlling interests).
  – IR personnel have to be well versed on technicalities to respond effectively.
After The UP-C IPO: Practical Tips For In-house Attorneys (continued)

• Expect questions from management
  – Management will often have to be briefed on tax, accounting, regulatory and other elements of living with the Up-C.
  – Management holders in the operating partnership need to be briefed on how to conduct exchanges.

• Expect to rely on outside advisors
  – Ongoing issues that arise in the wake of complex reorganizations and resulting Up-C structures require outside counsel, audit, investment banking and other advice.