PE Hub

Time to Come in From the Cold
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Six steps private equity sponsors should take now to prepare for a thawing IPO market.

There's no doubt the IPO climate has remained wintry – CNBC reported in November that "the IPO gold rush" that saw activity even into late 2021 "fizzled in 2022, and it's fizzling again" in 2023.

Despite the current forecast, private equity sponsors can and should spend this time making early plans when the market is cold so they can be ready to capitalize once the IPO window opens again.

This article explores six steps sponsors should take now as they begin the new year to maximize the eventual exit value of portfolio companies.

Consider how post-listing sell downs will occur

A traditional IPO is primarily a capital-raising event for the portfolio company – not an exit for the PE sponsor. While some liquidity may be achieved through a sale of sponsor shares at listing, full exits typically take years.

The allure of the IPO is not the immediate opportunity to exit, but rather the promise of enhanced exit opportunities in the future.

PE sponsors should engage early with investment banks specializing in the portfolio company's industry to understand how a post-IPO exit may play out. Such banks can assist in developing an exit strategy, considering various factors.

Consider early what level of control should be embedded for the sponsor's benefit in the IPO-ed company

Because an IPO is typically *not* a complete exit for a sponsor, a sponsor should build into the listing process appropriate post-closing governance rights.

Putting these arrangements in place prior to an IPO is easier than attempting to insert them after listing. Not only will a sponsor's control be eroded by virtue of the addition of public shareholders into the portfolio company, but governance rights typically erode over time in the face of investor pressure.

Representation on the public company's board is the first priority for sponsors, but it is possible for the sponsor to negotiate for consent rights over certain types of transactions, registration rights and super-voting shares.

Anticipate any debt refinancing

Portfolio companies should review any debt arrangements that may be accelerated by the IPO.

Sponsors and their investment bank advisers should consider relative costs of debt refinancing as compared with raising proceeds through the IPO and the impact on the sponsors' future exit opportunities. For companies with leverage put in place in a lower interest rate environment, financing may be a significant structuring consideration.

Build into the timeline for the registration statement the preparation of separate financial statements

Many IPO-ed portfolio companies grew through acquisitions. The registration statement used in the IPO may need separate audited financial statements for significant acquired businesses.

Sponsors should carefully consider whether separate financial statements for acquired companies or acquisition targets will be required in the registration statement and confirm that the relevant auditor will consent to including these statements in the registration and provide any required comfort letter. Moreover, sponsors should be mindful for the possible need of pro forma financial statements.

Identify an independent auditor early and put in place safeguards to maintain independence

Under SEC rules, a portfolio company undergoing an IPO will need financials audited by an independent accounting firm.

Independence is measured not just with respect to the portfolio company, but also with respect to individuals and entities that control or are under common control with the portfolio company. However, if either the sister entity of the portfolio company or the IPO-ing portfolio company is not material to the controlling entity, then the sister entity will not be deemed to be an affiliate of the IPO-ing portfolio company.

The look-back period for activities that automatically disqualify an auditor is one year. This can pose hurdles in the private equity space where portfolio companies often use public accounting firms for non-audit services, including preparation of financial statements and tax returns, valuation reports and implementation of financial information systems.

Plan for the termination of monitoring, management and similar agreements

Many portfolio companies enter into monitoring, management or similar agreements with their sponsors, providing sponsors with periodic and transaction-based fees.

Virtually all private equity-backed companies that IPO terminate such arrangements. The IPO itself is typically a termination event under the agreements, but – even when it's not – sponsors generally elect to end these arrangements. Documentation should be reviewed for termination mechanics, including any associated payments that will become due.

Sponsors will need to decide whether to enforce, waive or negotiate the fees that come due in connection with an IPO. While there is no explicit rule prohibiting the acceleration of monitoring and other fees, the SEC has stated that it believes that collecting fees for unperformed services breaches an adviser's fiduciary duties. Sponsors should analyze fees to ensure that they do not run afoul of the SEC's views on fiduciary duties.

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