Private Equity Alert

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Keeping the IPO Door Open – *What Every PE Portfolio Company Should be Doing Now to Maintain Optionality for an IPO in the Future*

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Portfolio companies do not stay portfolio companies forever - typically they either are sold or go public. Most sponsors will exit their investment through a sale to a strategic buyer or another PE firm. However, markets go up and down, and there may be periods in which it is more advantageous to complete an IPO rather than an M&A deal. These market "windows" do not stay open forever, so it is incumbent upon portfolio company management to be ready in the event their PE sponsor decides to pursue an IPO. In addition, many portfolio companies pursue both an IPO and a strategic sale at the same time to create price tension on the overall exit transaction. To maximize the leverage afforded by this "dual track" process, the portfolio company needs to be ready to actually consummate an IPO if it is determined that the IPO route will capture the most value. With this in mind, here are some things that every portfolio company can do now as a private company to keep the IPO option open and avoid significant delays in the IPO process.

Accounting

- Consider using a major accounting firm for your audits as underwriters and IPO investors expect IPO companies to provide audits from such firms
- Prepare for audits under PCOAB standards, which are required for an IPO and are more stringent than AICPA standards
- Confirm that your auditors are independent under the more stringent PCAOB standards in order to avoid the need to seek a waiver from the SEC or to replace auditors during the IPO process
- Prepare audits at the IPO company level

Financial Statements

- Consider preparing interim and quarterly results that are reviewed by your auditors (a "SAS 100" review) as they will be required or desirable for an IPO
- Assess significance of any acquired business to determine whether financial statements of the target would be required to be included in an IPO prospectus and, if so, negotiate for access to the necessary historical financial information
- Consider the number and makeup of your reporting segments, and whether they are consistent with how your company otherwise aggregates and reports information to key decision makers
- Consider reviewing the financial statement line item, non-GAAP and MD&A disclosure practices of your public company competitors to assess whether you should proactively make any changes to your company's reporting, financial statement, key performance indicators and disclosure practices in advance of an IPO

Material Agreements

- Analyze your debt agreements to ensure the IPO as contemplated is permitted, and be cognizant of the restrictions on communication that the potential IPO imposes in communications to debt holders
- Review your material agreements to determine whether they can be publicly filed with the IPO registration statement, as well as to identify what information is competitively sensitive and should be handled differently
- Review all personal loans and other credit arrangements made by the company to its directors and executive officers to determine whether such extensions of credit would be prohibited if the company proceeds with an IPO and to give the directors and executive officers enough time to repay or refinance such arrangements prior to publicly filing the IPO registration statement

Equity Awards

- Develop a methodology for establishing the value of equity awards granted to employees (including potentially obtaining contemporaneous independent valuations) during the 12-18 month period prior to the IPO
- Confirm equity award grant practices comply with securities laws, Rule 701 in particular, including the associated limits and information delivery requirements
- Consider the impact of an IPO on equity award vesting

Communications

- Keep the IPO in mind in establishing your investor and public relations policies and practices

Accounting

1. Consider using a major accounting firm for your audits as underwriters and IPO investors expect IPO companies to provide audits from such firms

Many portfolio companies select less expensive, smaller regional firms as auditors in order to save costs. While this may help profitability as a private company, it could result in having to change auditors when pursuing an IPO. Investment banks prefer, and may demand, that an IPO issuer provide audits and a comfort letter from one of the Big 4 accounting firms or one of the other 2-3 larger national firms as part of the IPO. Switching auditors as you are trying to pursue an IPO will be expensive, could result in a restatement or change in accounting policies, which could cause delay and missing the optimum IPO window.

2. Prepare for audits under PCOAB standards, which are required for an IPO and are more stringent than AICPA standards

As a private company, you may have prepared your audited financial statements in accordance with AICPA standards which meets the requirements of most credit agreements and indentures and works for a sale of the company. For an IPO, however, the SEC requires financial statements audited under PCAOB standards. PCAOB standards are more stringent, have lower thresholds for materiality and testing, result in expanded footnote disclosure, and may result in changes to financial statements or accounting policies. In addition, it is not uncommon for companies and auditors to identify material weaknesses and significant deficiencies in internal controls over financial reporting in connection with the application of PCAOB standards. It may be worth considering discussing the different standards and the impact of the application of these standards with your auditors so that you are prepared for the PCAOB audit in the event of an IPO.

3. Confirm that your auditors are independent under the more stringent PCAOB standards in order to avoid the need to seek a waiver from the SEC or to replace auditors during the IPO process

When selecting an auditor as a private company, many companies obtain audits that comply with U.S. GAAP from auditors that are independent under AICPA standards. While this standard complies with requirements for a private company, for an IPO, your auditors will need to be independent under the more stringent PCAOB and SEC standards. We have seen a number of instances where an auditor of a portfolio company is independent under AICPA standards but not under PCAOB standards. This is a particular risk for portfolio companies where the auditor may provide "prohibited services" to your sponsor's other portfolio companies. If your audit firm is not independent under PCAOB and SEC standards, you will have to either seek a waiver from the independence standards from the SEC's Office of the Chief Accountant or switch auditors, resulting in delay and expense.

4. Prepare audits at the IPO company level

Many portfolio companies conduct audits at the borrower level under their credit agreement or bond issuer level in order to comply with the related covenants and do not conduct audits at the entity that was the issuer of the equity issued to management and/or the private equity sponsor. While there are often internal reorganizations prior to the IPO for tax or other reasons, the issuer of equity is frequently also the entity that is the issuer in an IPO. Portfolio companies should be ready to conduct a PCAOB audit at the applicable level.

Financial Statements

5. Consider preparing interim and quarterly results that are reviewed by your auditors (a "SAS 100" review) as they will be required or desirable for an IPO

In an IPO, you will likely have to provide interim financial information, depending on timing. In addition, many underwriters suggest that you voluntarily include at least eight quarters of P&L information in the IPO prospectus. In order to include this interim information, the information will need to be subject to a review by your auditors, a so-called "SAS 100" review. You should consider preparing for a SAS 100 review of your quarterly financial information on an ongoing basis.

6. *Assess significance of any acquired business to determine whether financial statements of the target would be required to be included in an IPO prospectus and, if so, negotiate for access to the necessary historical financial information*

In addition to the company's historical financial information, up to three years of audited financial statements as well as interim financial statements of the target of material acquisitions or other business combinations that are completed or are probable are required in an IPO prospectus, depending on the size of the acquisition and its significance to the company (which is measured in a variety of ways, not all of which are intuitive). Pro forma financial information would also then need to be prepared and included in the IPO prospectus. While there are exceptions and qualifications to these rules, a key risk to avoid is being unable to include the required financial statements in an IPO prospectus because you do not have, and cannot prepare, historical financial statements for an acquired business. To avoid this risk, assess the significance of an acquisition at the outset to determine whether financial statements of the target would be required if an IPO is ultimately pursued and, if such information would be required, negotiate for contractual rights to have access to the necessary historical financial information.

7. *Consider the number and makeup of your reporting segments, and whether they are consistent with how your company otherwise aggregates and reports information to key decision makers*

Companies that are engaged in more than one line of business or operate in more than one geographic area may be required to include separate revenue and operating data for their business lines or geographic areas as more than one operating segment. The SEC often focuses during their review of an IPO prospectus on segment reporting. The SEC will review the financial statements, MD&A and other disclosure in the IPO prospectus, as well as on the company's website, to ascertain consistency in how the segments are presented and discussed. In addition, the SEC may request copies of internal segment reporting information that the chief operating decision maker receives to evaluate consistency between disclosure and internal process around segment reporting. Significant operating segments generally cannot be aggregated for disclosure purposes unless they share similar economic characteristics. As a result of the above, you should keep in mind that how information is aggregated and presented on the company's website, in press releases and other public disclosure, and to the company's chief operating decision maker should be consistent with how the company will want to present the information in the IPO prospectus. Having to redefine and recast segment information during the review period in response to SEC comments can add significant delay and expense to the IPO process.

8. *Consider reviewing the financial statement line item, non-GAAP and MD&A disclosure practices of your public company competitors to assess whether you should proactively make any changes to your company's reporting, financial statement, key performance indicators and disclosure practices now in advance of an IPO*

Consider benchmarking what your company's public company competitors or otherwise similarly situated public companies do with respect to the following: selection, makeup and description of line items included in the financial statements; non-GAAP financial information disclosure and other key performance metrics (e.g., EBITDA); and management's discussion and analysis (MD&A). To the extent a change to your company's existing practices in any of these respects makes sense (to align with what public companies do or otherwise), consider adopting the change now rather than waiting for the IPO process. Early adoption avoids having to make the change in retrospect to past periods and reduces potential delays or added expense in the IPO process.

Material Agreements

9. *Analyze your debt agreements to ensure the IPO as contemplated is permitted, and be cognizant of the restrictions on communication that the potential IPO imposes in communications to debt holders*

The change in the overall ownership of the company as a result of selling stock to the public in the IPO could trigger change of control provisions under the credit agreement (potentially resulting in an event of default) or the indenture (potentially resulting in an obligation to offer to repurchase the bonds). In particular, existing credit agreements should be reviewed to determine whether an IPO would trigger the change of control provisions and cause an event of default so that, for example, the company can proactively obtain a waiver at an opportune time in advance of the IPO. In addition, if the entity that is going public is different from the obligors under the credit agreement, confirm that the borrower under the restricted payment and other covenants can dividend money to the IPO entity to pay for fees and expenses associated with the IPO. Finally, confirm the debt agreements (and, probably more likely in this regard, any shareholder agreements and operating agreements with significant business partners) do not restrict share issuances or require the proceeds of the IPO to be used in any particular way (e.g., swept to repay the debt).

As the IPO progresses, particularly after investment banks have been retained to undertake the offering, proceed with caution with respect to what is communicated to the administrative agent and lenders under the credit agreement. Securities laws impose communication restrictions that vary depending on the stage of the IPO. In general, communications with lenders should be factual in nature, limited to the type of information historically provided to the lenders and as required by the terms of the credit agreement, and, without prior discussion with the company's counsel, avoid referencing a potential IPO.

10. Review your material agreements to determine whether each can be publicly filed with the IPO registration statement, as well as to identify what information is competitively sensitive and should be handled differently

In light of the requirement that the company must file as an exhibit to the registration statement the company's material contracts (other than contracts entered into in the ordinary course of business), the company should review all of its existing material agreements (including debt agreements) for certain contractual and disclosure of sensitive information issues, and consider these issues when entering any new material agreement. A consent or notice may be required by the terms of the agreement to file and disclose the agreement publicly. You should also ensure any new material contract permits you to comply with public reporting filing obligation.

The SEC on a limited basis will grant requests that certain information contained in the agreement be redacted, thereby protecting the redacted sensitive information from public disclosure. Requests for confidential treatment typically involve trade secrets or commercial or financial information that could harm the company competitively if publicly disclosed. The SEC is unlikely to grant the request, though, if such information is material to making an investment decision in purchasing the company's securities.

11. Review all personal loans and other credit arrangements made by the company to its directors and executive officers to determine whether such extensions of credit would be prohibited if the company proceeds with an IPO and to give the directors and executive officers enough time to repay or refinance such arrangements prior to publicly filing the IPO registration statement

The Sarbanes-Oxley Act prohibits an issuer from making, arranging or having outstanding a personal loan to or for any director or executive officer. While there are certain practices that are acceptable (such as certain cash advances to reimburse travel and similar business expenses), you should review all loans and other credit arrangements with the company's directors and executive officers sufficiently far in advance of the public filing of the IPO registration statement to determine whether such loan and other credit arrangements will need to be repaid or refinanced from another capital provider, and provide the company's directors and executive officers enough time to do so prior to the filing of the registration statement. Also keep in mind that regardless of whether such loans have been repaid, their existence may have to be disclosed as related party transactions.

Equity Awards

12. Develop a methodology for establishing the value of equity awards granted to employees (including potentially obtaining contemporaneous independent valuations) during the 12-18 month period prior to the IPO

In reviewing the prospectus during the comment process, the SEC typically makes inquires about the methodology the company employed when establishing the value of equity awards granted to employees during the 12-18 month period prior to the IPO. If the SEC determines that the company issued equity awards at valuations substantially lower than the

IPO price that cannot be otherwise supported or justified ("cheap stock"), the company will likely have to incur a compensation expense that will have a negative impact on earnings and may result in a restatement, and the employees may be deemed to have received taxable income for U.S. income tax purposes. Note this cheap stock determination will be made in hindsight with the benefit of knowing the expected IPO price.

As a result, in anticipation of inquiries, companies often obtain contemporaneous independent valuations by a qualified independent appraiser with respect to all equity awards during 12 – 18 month period prior to the IPO process. This independent report, together with a detailed explanation of a well-crafted methodology for establishing the value of equity awards, can help resolve cheap stock inquiries from the SEC. In addition, as a company gets closer to the IPO, a company may consider granting options with a strike price equal to the IPO public offer price and subject to the IPO closing successfully. In any event, discuss your approach to the value of equity awards leading up to an IPO with your accountants, lawyers and compensation consultants.

13. Confirm equity award grant practices comply with securities laws, Rule 701 in particular, including the associated limits and information delivery requirements

All sales of securities, including the grant of equity awards, need to be made pursuant to an effective registration statement or an exemption from the registration requirements. Failure to comply with these requirements can mean that, among other bad things, the company may be required to rescind the grant, repurchase shares and unexercised equity awards and recognize a contingent liability if the recipient does not participate in the repurchase. In addition, you will have to provide a representation and warranty regarding such compliance in the IPO underwriting agreement and confirm such compliance in the IPO registration statement.

As pre-IPO companies do not register the equity grants, the common (but not exclusive) exemption used for pre-IPO companies in this regard is Rule 701. Rule 701 provides, among other things, that the amount of securities that may be sold during any 12-month period (fixed or on a rolling basis, consistently applied) may not exceed the greatest of $1 million, 15% of total assets and 15% of the class outstanding. In addition, if the aggregate sale price or securities sold during the applicable 12-month period exceeds $10 million, the company must provide certain disclosure a reasonable period of time before the date of sale (or, in the case of options, the date of exercise of the option), including a description of the material terms of the plan, risk factors and financial statements. As a result, the company should discuss with its securities counsel available securities law exemptions for granting equity awards, and unless an exemption other than Rule 701 is available, confirm equity grants are made within the Rule 701 limits and likely prepare and deliver the necessary disclosure package if the company reasonably anticipates the company may cross the $10 million threshold at any point. Grants to senior management, which often make up a significant portion of equity grants, may also be exempt pursuant to Regulation D (the private placement exception).

14. Consider the impact of an IPO on equity award vesting

Many equity awards have performance based vesting metrics that may be affected by an IPO, resulting in awards vesting at or shortly after an IPO. If restricted stock vests or restricted stock units are settled at the time of the IPO, it can result in withholding obligations for the company as well as tax consequences to the holders (who may not be able to sell any equity interests post-IPO as a result of securities law considerations or lock-up agreements to meet the resultant tax obligations). IPO vesting could also adversely impact employee retention. Companies may want to consider modifying performance based vesting metrics in connection with the IPO to time based or other types of vesting. In sum, companies should take vesting and potential tax and other consequences of equity awards into account if an IPO is possible.

Communications

15. Keep the IPO in mind in establishing your investor and public relations policies and practices

Entering the formal IPO process (which is typically at the point of selecting underwriters) triggers significant restrictions on your ability to communicate publicly. These restrictions – many of which are counterintuitive and are not limited to a formal offer of securities – include conditioning the market by increasing the communications activity of the company, communicating with potential IPO investors or communicating information that isn't focused on marketing the company's products and services but on the benefits of the company as an investment. It is generally advisable not to discuss an IPO or the company's financial projections publicly for a number of reasons:

- Risk of violating the securities laws
- Creating a market expectation that you might not meet
- Reducing the benefit you might gain from the confidential filing process
- Raising risk of liability

One of the major considerations in determining if certain types of communications are permitted during the IPO process is whether the communication is consistent with past practice in terms of the type of information conveyed and the manner and frequency of the communication. Companies rely on this in continuing to convey financial and forward-looking information to their investors and lenders during the IPO process. Subject to the caveat above, your existing communications profile will also allow you to continue to convey information to the public (consistent with past practice) during the IPO process. As a result, you should consider and balance the benefits that establishing this practice will provide during the IPO process in determining your investor and public relations profile as a private company.

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