

---

## COVID-19: Private Equity in a Coronavirus World

MARCH 26, 2020

For most private equity sponsors and their portfolio companies, the effects of the COVID-19 shockwave have started to give way to the realization that, for the near term, uncertainty is the new normal. Although many are still sorting through the new challenges every day brings, as the nation settles into social distancing, remote work, restricted travel and other realities caused by the pandemic, new strategies and tools are emerging to help private equity sponsors and their portfolio companies manage through the crisis and prepare for what may come next.

### *New Terrain for Private Equity*

COVID-19 will cause an unprecedented disruption to the global economy. Here in the United States, millions of Americans have been sent home from work and many businesses have closed their doors, at least temporarily. During the Great Depression, the highest rate of unemployment in the United States was 24.9%. Last week, Federal Reserve Bank of St. Louis President James Bullard warned that COVID-19 could cause the US unemployment rate during the second quarter to hit 30% because of workplace shutdowns, coupled with a forecasted 50% drop in GDP over that same period. Some policy makers expect the pandemic to impact the US economy deep into the second quarter. US Defense Secretary Mark Esper recently observed, judging from the experiences in China, South Korea and elsewhere, “I think we need to plan for this to be a few months long at least.” Foreshadowing what the United States might expect over this period, during the first two months of 2020, China saw home sales shrink by 33%, construction drop by 25%, retail sales fall by almost 20% and factory output drop by double digits.

The good news is that economic fundamentals immediately before the coronavirus crisis were strong. The US economy was at the tail end of one of the longest economic expansions in its history. In February, the Federal Reserve (the Fed) described the economy as growing at “a modest to moderate rate over the past several weeks.” In the weeks just prior to the coronavirus outbreak in the United States, economist Joel Naroff stated, “Going into any potential coronavirus slowdown, the economy is in good shape.” And while Morgan Stanley’s chief economist, Chetan Ahya, expects the virus to cause a “sizeable shock” in the first half of 2020, Morgan Stanley also expects the impact to be short-lived, predicting US GDP growth rebounding quickly to 3.1% in the second half of 2020. Given all this, there is reason to believe that the impact in the United States of COVID-19 could be

severe, but also brief.

While many portfolio companies are undoubtedly at risk as the outbreak accelerates and the economy slows, private equity firms and government have been quick to move in ways that should help the private equity industry weather the storm.

- **Remote Working and Better Stakeholder Engagement:** Many sponsors and their portfolio companies were able to anticipate the crisis, form crisis management teams and transition quickly to remote working environments, making real-time crisis management possible in an unprecedented manner. Many sponsors and executives also involved key stakeholders in their crisis management teams—major customers and employees, for example, rather than limiting their focus exclusively to short-term financial management. This may be evidence that sponsors expect the turbulence to be short-lived, but even still, the move to widen transparency and communication has helped calm nerves in many portfolio companies and their stakeholder groups. Many middle market funds, in particular, have also convened limited partner town halls, conference calls or issued off-cycle portfolio company financial reports to ease investor concerns and have expressed a commitment to more of the same if the crisis continues.
- **Revolving Lines of Credit:** During the 2008 financial crisis, many severely distressed companies were among the first to draw down on their revolving lines of credit in advance of restructurings. Now, historically low interest rates and concerns over later term liquidity are prompting many portfolio companies that are financially strong to tap their revolving credit lines. Sponsors and portfolio companies that are still considering whether to draw down should consult with legal counsel on the requirements for doing so. Careful consideration should be given to the timing of those draws and whether a borrower expects further deterioration of its business and if so, over what period of time. For a more detailed review of COVID-19-related issues in credit agreements, please see [here](#).
- **Tax Relief:** The federal government and many states have announced changes in tax filing and payment dates in response to the COVID-19 pandemic. The Coronavirus Aid, Relief, and Economic Security (CARES) Act that was passed in the US Senate on March 25, 2020, provides for several items of tax relief of interest to private equity funds and their portfolio companies. In addition to deferrals of employment tax liabilities and/or payroll tax credits to employers, these include:
  - The 80%-of-income limitation on the use of net operating loss (NOL) carryovers and the excess business loss limitation for noncorporate taxpayers, which were enacted in 2017, would both be suspended until a taxpayer's first taxable year beginning after December 31, 2020, and for subsequent years would be applied independently of certain rate-reducing deductions in a manner that would generally mitigate the effect of the limitations.
  - NOLs arising in any taxable year beginning after December 31, 2017, and before January 1, 2021 (other than a year in which the taxpayer is taxed as a real estate investment trust), could be carried back up to five years. Carrybacks would not be permitted to offset a repatriation tax liability under Internal Revenue Code (IRC) Section

965.

- NOL carrybacks originating in tax years ending in the 12 months prior to enactment (i.e., March 2019, or later), would be eligible for the “quick” refund procedure under existing IRC Section 6411. The CARES Act would extend the period for filing quick refund applications for NOLs arising in tax years that span 2017 and 2018.
- Currently, net interest expense can be deducted only to the extent of 30% of a taxpayer’s earnings before interest, tax, depreciation and amortization, as computed for tax purposes (EBITDA). The CARES Act would increase the limitation to 50% of EBITDA for taxable years beginning in 2019 and 2020. In addition, for a taxable year beginning in 2020, taxpayers could choose to apply the limitation by reference to their EBITDA in their last taxable year beginning in 2019. This will help portfolio companies boost their liquidity if they have debt or increase their borrowing during the crisis.

For further updates on this legislation as it progresses, please visit the [WilmerHale Coronavirus \(COVID-19\) Center](#).

- ***Small Business Paycheck Protection Program Loans:*** If enacted into law, the CARES Act would make \$349 billion available to companies under the Small Business Administration’s (the SBA) Paycheck Protection Program. Eligible businesses may receive guaranteed, forgivable loans, up to \$10 million, equivalent to 2.5 months of payroll costs. If borrowers spend the loan proceeds on payroll support (not including costs for individuals compensated above \$100,000 annually), such as employee salaries, paid sick or medical leave, insurance premiums, and mortgage, rent, and utility payments between February 15, 2020, and June 30, 2020, the loans are eligible for forgiveness (converting them from loans to grants). However, loan forgiveness will be reduced by the amount that a reduction in total salary or wages to any employee exceeds 25% of the employee’s total salary or wages during the most recent full quarter prior to loan inception. The CARES Act also waives the collateral and personal guarantee requirements under this program and sets a maximum interest rate of 4%.

Eligible “small businesses” include the self-employed and any business that meets the applicable small-business size standard for its industry, and any other business with 500 employees or fewer, or a higher headcount standard for the industry as based on the company’s NAICS Code. For applicable size of employee standards, click [here](#). In determining the number of employees, the SBA’s affiliation rules include all employees of affiliated entities that have control or the power to control the business, or that are under or potentially under common control with the business, with exceptions for investor rights that are customary minority shareholder protections. In the private equity context, this would typically include the number of employees in the private equity fund, as well as some or all of the fund’s other portfolio companies.

Businesses controlled by private equity funds may be able to access Paycheck Protection Program loans under the CARES Act, assuming they meet the applicable size standards.

Portfolio companies of large and more mature funds may have a more difficult time qualifying because of the affiliation rules, although since companies owned by newer or smaller funds have fewer affiliated employees, they may still be able to qualify. In addition, the CARES Act waives the affiliation rules for businesses in the hospitality and restaurant industries, franchises that are approved on the SBA's Franchise Directory, and small businesses that receive financing through the Small Business Investment Company program.

- **Portfolio Company Valuations:** Sponsors will want to monitor events closely to know when to review portfolio company valuations, not only under their fund documents but also to help ensure their portfolio companies' ongoing compliance with IRC Section 409A. IRC Section 409A regulations provide that "the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation." This applies to partnership profits interests and stock option awards, valuations of which should always take into account all current information that may affect value. While there is no immediate problem with granting profits interests and stock options at above fair market value, new valuations will almost certainly be required in the future if companies recover following the crisis and resume their granting practices.
- **Federal Reserve Programs:** The Fed has also announced extensive new measures to support the economy. For example, the Fed has recently announced the establishment of two facilities to support credit to large employers—the Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance and the Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity for outstanding corporate bonds. The Fed has also announced the establishment of a third facility, the Term Asset-Backed Securities Loan Facility (TALF), a revival of a facility established in the last crisis, to support the flow of credit to consumers and businesses by enabling the issuance of asset-backed securities (ABS) backed by student loans, auto loans, credit card loans, loans guaranteed by the SBA and certain other assets. These programs are established by the Fed under the authority of Section 13(3) of the Federal Reserve Act, with approval of the Treasury Secretary. The Fed has also announced its intention to establish a Main Street Business Lending Program to support lending to eligible small- and medium-sized businesses, complementing efforts by the SBA.

## *Looking Ahead*

Beyond the immediate challenges the crisis poses to business and the economy, the crisis will inevitably present opportunities for private equity to help advance economic recovery. Distress investors are already preparing to act, tracking opportunities to acquired distressed assets and discounted debt.

And unless there is a prolonged pause on economic activity, the outlook for the private equity industry remains positive as well. Based on industry data, private equity funds continue to sit on record levels of committed capital (estimated at \$2 trillion, with over \$700 billion of that in buyout funds). As was the case after the 2008 financial crisis, this capital is poised to inject much-needed

liquidity into the economy. In addition, after years of unabated valuation growth, buyout funds will likely see valuations cool. A historically low interest rate environment coupled with depressed valuations could make for a rapid rebound in buyout activity, although a delayed resurgence in travel, an important part of deal origination, could temper that pace.

It may be too soon to predict what deal terms will look like in a post-COVID-19 world, but there are early indications. Valuations, which are inherently based on trailing EBITDA, will be uncertain, and as a result, buyers may be heavily reliant on earnouts, and could demand higher rollover amounts, particularly for new platform company acquisitions. Underwater equity incentives may necessitate a greater use of transaction and retention bonus programs, which may be less tax advantageous to target executives than profits interests, by contrast. Sellers may wish to monetize tax losses in transactions, and buyers might expect to have to negotiate those points more exhaustively than in recent years, especially if sellers try to make up ground from depressed valuations.

And then there will be the residual effects of the impact on deal terms from COVID-19 itself. In a very short time, COVID-19-related issues have moved quickly into M&A agreements. References to pandemic-related impacts have already appeared in MAE definitions, representations and warranties; interim operating covenants between signing and closing; financing commitments; and related deal termination provisions. Representations and warranties insurance providers have also moved quickly to exclude coverage for COVID-19-related matters.

Whether the recent movement in deal terms is more short-lived or enduring depends on the length and severity of the pandemic's impact. And while sponsors and their portfolio companies keep an eye on the future, shouldering the burden of the present is foremost on their minds. We continue to value our work with sponsors and their portfolio companies to confront these challenges.

---

## *Authors*

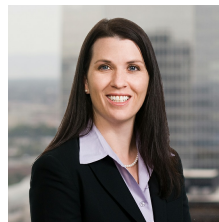


**Keith A. Trammell**

PARTNER

✉ [keith.trammell@wilmerhale.com](mailto:keith.trammell@wilmerhale.com)

☎ +1 212 295 6329



**Chalyse Robinson**

PARTNER

✉ [chalyse.robinson@wilmerhale.com](mailto:chalyse.robinson@wilmerhale.com)

☎ +1 720 598 3442



## Mick Bain

**PARTNER**

Chair, Transactional Department

✉ [michael.bain@wilmerhale.com](mailto:michael.bain@wilmerhale.com)

☎ +1 617 526 6158



## Barry J. Hurewitz

**PARTNER**

✉ [barry.hurewitz@wilmerhale.com](mailto:barry.hurewitz@wilmerhale.com)

☎ +1 202 663 6089