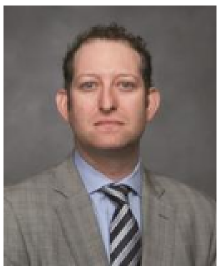
Private Equity in Silicon Valley: Healthy Activity Amid New Concerns to Navigate

PRESENTED BY PAUL HASTINGS



Private equity firms are expected to continue making significant investments in high tech, says Paul Hastings partner Alex S. Kaufman, with deal work in the areas of Software as a Service (SaaS), artificial intelligence (AI), autonomous driving and healthcare IT being particularly attractive for private equity investors.

Kaufman, who advises private equity funds, growth equity funds and standalone technology companies on mergers and acquisitions and equity financing transactions and is based in the firm's Palo Alto office, believes there will be a tremendous amount of activity this year in the middle market in private equity. "If you look at the sheer amount of dollars that have been raised by private equity firms over the last couple of years that has not been deployed, it's a good bet there will be significant growth in the near term," he asserts.

Concurrently, private equity firms are increasingly grappling with issues that impact how they do business and which companies receive investments. Due diligence, high valuations, foreign investment and national security are areas that will be of heightened consideration in the near term.

Due diligence is paramount

Kaufman contends there will be increased focused on "#MeToo due diligence," within the backdrop of the larger #MeToo movement. Limited partners, for example, are increasingly asking general partners to ensure that companies receiving investments won't be involved in the next scandal on the front page of the newspaper. "You are seeing a more socially-conscious approach to due diligence as investors – particularly limited partners in private equity – are starting to raise that concern."

Kaufman also emphasizes that the general public is paying much more attention to private equity activity. These funds are portrayed in the media as being business partners, not simply silent investors. In fact, the trade group the Investment Management Due Diligence Association has recommended investors review personnel processes, departures and a manager's use of non-disclosure agreements, according to Bloomberg. Additionally, the Institutional Limited Partners Association, the leading private equity trade group, is considering rules to guide investors' approach to these issues.

"There is a significant public relations risk inherent in making investments," explains Kaufman. "It's leading private equity funds to make sure they do the proper due diligence on the front end to try to alleviate those concerns. Asking the right questions doesn't always mean you are going to get the right answers. But it shows you are making the investment with the awareness of these issues and with a good faith attempt to discover them before committing to invest in a company."

High valuations raise concerns, but aren't stopping investments

While Kaufman says he hears complaints about high valuations of target companies, many investors are still keen to jump on a great opportunity and compete for the asset, whether their goal is to finance or acquire the company. This will continue to foster sky high valuations. Making intelligent investments at the right time has become a key concern for private equity investors.

"At the end of the day, it's simply supply and demand," Kaufman asserts. "There's a certain amount of capital and there's a certain number of companies. So long as the tax treatment of the investments continues to be favorable and tax rates in general continue to be relatively low by historical standards, I think you will continue to see a tremendous amount of activity. When the market turns and how hard it turns is anybody's guess. But markets are cyclical. I think in time you will see the same thing with venture valuations."

Foreign investment and national security move to the forefront

Investors will need to become more attuned to the filing requirements of the Committee on Foreign Investment in the United States (CFIUS), which has been strengthened through recent legislation, says Kaufman. The body is able to limit foreign investments in industries seen as important to national security and potentially unwind deals that have already been made. Kaufman also says investors will need to become increasingly creative in how they structure transactions due to CFIUS and companies will end up being more selective in terms of who they choose to partner with.

Kaufman further explains that many foreign companies have some US nexus – maybe they operate abroad, but they have a US parent company, or they have a foreign parent with a US subsidiary – and they never thought about the potential risks of raising money from non-US investors. Investors that are subject to CFIUS are very attuned to it because it surfaces in every transaction; however, there are many growing, venture-backed companies that are not familiar with the requirements of the current legislation. Failing to file the mandatory declaration with CFIUS – or filing and closing a deal before being given clearance – can result in the government unwinding the transaction.

"Many CEOs are completely unaware of the issue and don't become educated on it until they have already selected a fund to finance their next round," explains Kaufman. "Then, you have to think about how to try to structure it around CFIUS."

*For more information on trends in private equity and navigating today's concerns, please contact **Alex S. Kaufman**, Partner, Corporate Department at Paul Hastings, or visit PaulHastings.com.*