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Four Questions To Ask Before An IPO

Are there advantages to going public? Certainly, but senior management should ask some basic questions first.

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We in the midstream industry know two truisms about IPOs:

- Market opportunity windows open and close quickly; and
- Preparation and execution are necessary for success.

Private investors in midstream companies will seek the liquidity and value uplift provided by an IPO throughout the next year, but management must be prepared and nimble. With these factors in mind, we offer high-level thoughts on four practical questions often asked in advance of an IPO.

1. What are the benefits?

Cash—The most obvious benefit from an IPO is the receipt of a large amount of cash. If the issuer is selling the equity, a primary offering, it may choose to use the cash received to fund growth through an acquisition, expansion of facilities or paying down debt.

Private equity or parent-company sponsors and founding shareholders often sell part of the equity in the IPO, a secondary offering, as a way to partially exit their investment. Recent energy IPOs have involved sales by both companies and their sponsors.

Access to capital—A midstream company typically experiences a market value increase upon IPO and, ideally, for a time thereafter. A public company can raise cash for its capital needs by issuing securities in the public markets or privately—presumably at a higher price than it could

21%

Coporate tax rate

Tax On $100 Of Earnings	2017	2018-2025	2026 and Beyond
Corporations & Shareholders (combined)	$50.47	$39.80	$39.80
MLP Unitholders	$43.40	Effectively $33.40	$43.40
Delta	$7.07	$6.40	($3.60)

100%

Bonus Depreciation

PV-10 Of Depreciation Deductions	35% Rate	21% Rate	Expensing
Gathering System (7-year MACRS)	$0.28	$0.17	$0.21
Unregulated Pipeline (15-year MACRS)	$0.20	$0.12	$0.21

**Regulated business excluded*
**Phases out in 20% increments annually beginning 2023 until it is zero in 2027*

as a private company. The liquidity of its equity provides access to a greater universe of investors and even makes obtaining bank financings easier.

In addition, public equity can be an attractive currency in acquisitions by reducing the company's need for cash or debt and providing an attractive tax deferral for the target's shareholders.

Equity compensation—Equity-based compensation is used to attract, motivate and retain key employees. Stock options or other equity-based grants for private companies can be a risky proposition if the business is unsuccessful or if it never reaches liquidity.

The ability to sell the shares underlying the equity compensation in the stock market provides more visibility to actual cash returns, making the compensation more attractive.

Publicity—IPOs often make the company known to a new group of potential investors and industry relationships. During the IPO process, underwriters aim to place the shares with high-quality, longer-term investors, a move intended to contribute to stability in the market value.

The company will also develop relationships with research analysts, who increase public awareness of the company through ongoing research coverage and provide feedback to management over time. After the IPO, the company will provide continuing disclosure through U.S. Securities and Exchange Commission (SEC) filings, quarterly earnings calls and investor presentations in the active midstream conference circuit.

2. What are the costs?

Compliance and disclosure—The other side of being able to access capital from the public is being required to publicly disclose sufficient information. Companies that are publicly traded are subject to detailed disclosure laws about their financial condition, operating results, management compensation and other areas of their business.

The underlying basis of the SEC's reporting requirements is to keep markets informed on a regular basis, in a transparent manner. The company must not only disclose positive information but also adverse events and risks. Companies must put in place disclosure controls and procedures and internal control over financial reporting and disclose the effectiveness of these controls.

These disclosure and control requirements are extensive, increase general and administrative expense and require liability management. Establishing the processes necessary to meet these obligations is a significant undertaking and may require hiring personnel or consultants. It is beneficial to address them systematically over time rather than all at once.

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Less control—Even if the sponsor or original owners maintain control of the board of directors of the public company, whether through an MLP structure or by owning more than 50% of the public equity, the public company must comply with certain governance requirements after the IPO. Among other requirements, the company must maintain an audit committee comprising three independent directors and, depending on its structure, may be required to have a majority independent board.

3. What should I expect from the SEC review process?

Management should understand and review with securities counsel the technical aspects of the SEC process, which are covered in the *Gibson Dunn IPO Guidebook*. We also offer the following insights:

Current SEC climate—The regulatory climate is good for IPOs. Between the JOBS Act of 2012 and the FAST Act of 2015, Congress has taken significant steps to lessen the disclosure and accounting burden of an IPO process.

The SEC has also taken steps to affirmatively encourage capital formation by loosening requirements for smaller companies and simplifying certain disclosure requirements in IPO registration statements and public company reports. The SEC chairman has expressed a desire to see more publicly traded companies, and the number of staff comments seems to have decreased. The staff also has expressed a willingness to review requests for waivers of certain financial statement requirements. Additionally, there is legislative momentum to reduce the red tape related to the IPO process as illustrated by the U.S. House of Representatives passing the JOBS and Investor Confidence Act, or the JOBS Act 3.0. The JOBS Act 3.0 seeks to, among other things, streamline the IPO process and extend certain disclosure and offering exemptions currently available to only emerging growth companies to all companies.

SEC review—Every IPO registration statement will be reviewed by the SEC's Division of Corporation Finance. Typically, one attorney and one accountant are assigned to a registration statement. Open dialogue between counsel and the staff will be important.

The review process is one of comment on disclosure, not merit. The SEC does not pass on the quality of the company. The staff asks questions and makes comments about the registration statement and related offering

materials. The staff also might suggest more disclosure on a certain topic, and might require additional information to ensure that the company complies with the disclosure rules.

Expect comments on the first filing in 30 days and half the response time for each subsequent amendment (i.e., 30 days, 15 days, seven to eight days). The review process will be longer if new financial statements are required or the staff issues difficult accounting comments.

Hot-button issues—When preparing the registration statement and its financials, anticipate the SEC's hot-button issues. Areas of focus in disclosure currently include cybersecurity risks and their management, robust but tailored risk-factor disclosure, the impact of tax law changes, related-party transactions and non-GAAP financial measures.

Areas of focus in accounting include cheap stock (i.e., granting stock to employees pre-IPO at below-market value even if market value is increased as a result of the IPO valuation), reporting segments and the new revenue recognition standard. If there are any questions, a pre-filing conference with the staff can make the review process more efficient.

Financial statements—One of the key areas of delay is the availability of financial statements. This is particularly true when the company has built its business through acquisition of businesses over time. The company will be required to present two or three years of GAAP financial statements, audited and reviewed in accordance with Public Company Accounting Oversight Board (PCAOB) and SEC standards, although a company may omit from its IPO registration statement annual and interim financial data it reasonably believes will not be required at the time the company launches the offering.

The company may also be required to present financial statements for recently acquired businesses. In light of the critical nature of financial statements in the IPO process, in the two or three years before the IPO it is helpful to engage a PCAOB audit firm to review financial statements on a quarterly basis.

Changing auditors at the time of the IPO causes delay and expense. In addition, M&A agreements should provide the company with the right to receive financial statements of the target that are required, or deemed appropriate, under securities regulations.

Communications—It is important to understand and educate all company personnel about the limitations on communications in specified periods before, during and after the IPO process. The rules around communications are strict and can be tough to navigate, particularly given that most companies keep registration statements confidential until a few weeks before launching the IPO.

There are acceptable methods for communicating with the market in advance of the IPO (e.g., "testing the waters" meetings with investors in emerging growth companies). Regular communications with customers and others may also be acceptable if proper protocols are followed. The SEC and plaintiffs' lawyers are monitoring these communications, and the SEC will ask for copies of certain materials.

Violation of communications rules can result in a delay in the IPO process, rescission rights for investors in the IPO and liability for the company.

4. What is the impact of tax reform?

We cannot overstate tax reform's impact on domestic growth, including in the midstream sector, and tax reform's sunsetting provisions may impact the timing of the IPO. Tax can seem complex, but two numbers summarize tax reform's largest drivers of such growth: 21% and 100%.

21%—A large, and notably, permanent, change in tax reform was the reduction of corporate tax rates from 35% to 21%. One rarely sees such a deep reduction in tax rates, and it is even rarer to see it as a permanent item now that so many tax changes occur through the budget reconciliation process, which often necessitates sunsetting provisions. The new, lower corporate tax rate changes the comparative after-tax benefits of flow though and corporate structures (possibly permanently).

The accompanying table shows the amount of federal taxes payable by corporations and their shareholders relative to those of flow-through MLP unitholders. Under prior law, the delta approximated $7.07 per $100 of earnings (assuming the corporation distributes all of its after-tax earnings or has sufficient shareholder turnover such that shareholders regularly pay long-term capital gains taxes).

Tax reform mitigates that $7 benefit during the period of 2018-2025 because of the new 21% corporate tax rate, and a new 20% trade or business deduction on flow-through income does not entirely overcome the difference.

A new member of the Midstream 50 for 2018 is BP Midstream Partners, which placed No. 47 on the list. CEO Rip Zinsmeister, center, rang the New York Stock Exchange's opening bell to celebrate the partnership's IPO. *Source: New York Stock Exchange*

Note the 20% deduction has certain limitations, but MLP unitholders generally receive its benefit, resulting in an effective 33.4% tax rate.

Importantly, the tax preference for flow-through taxation flips in 2026 and beyond if the sunset provisions take effect. This could be a dubious assumption, given that sunsetting taxpayer-favorable provisions often get extended as lawmakers kick budgetary concerns down the road. A number of federal elections before 2026 will impact the direction of tax laws and this delta between MLPs and corporations, two midterm (2018 and 2022) and two presidential (2020 and 2024).

Political uncertainty means one cannot reliably assume that MLPs' comparative tax benefit on $100 earnings remains $6.40 long-term.

100% bonus—The new 100% bonus depreciation rule will also drive domestic growth. The tax code has had bonus depreciation for years but never a rule this generous to apply to 100% of the cost, while including purchases of pre-existing assets available in the market.

Under the new rule, a taxpayer may take a full deduction even for buying a used pipeline from a third party so long as the pipeline is not a regulated gas or steam pipeline.

The accompanying table illustrates the value of the deduction by comparing the PV-10 of the tax benefits of placing in service a gathering or unregulated transmission pipeline asset under general depreciation rules, which at a 21% tax rate amounts to about 17 cents and 12 cents, respectively, on every dollar of investment. The 100% bonus enhances that tax value to 21 cents on the dollar.

Note that the rule excludes regulated gas businesses from 100% bonus. To understand why, it is best to consider a regulated business like an electric utility. A utility wants to be excluded from bonus depreciation because a utility must pass the tax benefit through to its rate payers anyway. Any bonus depreciation in this regulated environment fails to incentivize new domestic investment, and to pay for bonus depreciation, the government raises revenue with a limitation on the deductibility of interest expense in a trade or business, which limitation would hurt electric utilities. Therefore, electric utilities get excluded from bonus depreciation and get to avoid new limitations on interest deductibility.

Gas (but not oil) pipelines get caught up in the same regime if the gas pipeline's rates or prices charged to customers are approved or directly set by federal, state or local agencies, essentially capturing them in the electric utility exception.

IPO proceeds are often taxable to a private equity or parent-company sponsor, but the ability to take bonus depreciation on another unregulated expansion project can substantially mitigate this tax acceleration or increase tax deferred returns to investors of the public company. ■

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The authors are partners in the Houston office of Gibson, Dunn & Crutcher.

PV-10 Of Depreciation Deductions

	35% Rate	21% Rate	Expensing
Gather system, 7-year MACRS*	$0.28	$0.17	$0.21
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** Modified Accelerated Cost Recovery System*