Tax Receivable Agreements Market Update
Q4 2023

Houlihan Lokey is pleased to present its Tax Receivable Agreements Update for Q4 2023, which overviews the market for tax receivable agreement (TRA) holders, investors, and industry stakeholders.

In this issue, we highlight recent public TRA issuances, buybacks, and M&A transactions in Q4 2023. We also discuss how Up-C collapses impact TRA holders for the reader.

We hope you find this quarterly update to be informative and that it serves as a valuable resource for you to stay up to date on the TRA market. If there is additional content you would find useful for future updates, please email us with your suggestions. We look forward to staying in touch with you.

RECENT TRANSACTIONS IN Q4 2023

New TRA Issuances

There were three new public TRA issuances in Q4 2023.

Target/Issuer	Transaction Type	IPO/Completion Date	Implied Market Cap ($M) at 1/2/2024	Notes
flyexclusive	Up-C De-SPAC	12/27/2023	164.8	▪ The SPAC, EG Acquisition Corp., was sponsored by EnTrust Global and GMF Capital, LLC.
BIRKENSTOCK	Traditional IPO	10/11/2023	7,330	▪ TRA includes U.S. and non-U.S. pre-IPO tax assets.
Falcon's Beyond	Up-C De-SPAC	10/6/2023	2,150	▪ Based on the company's historical losses, it did not record an adjustment for deferred assets or liabilities pursuant to the business combination. ▪ The unrecorded liability following the business combination is ~$201.4 million.

M&A Events Impacting TRAs

This quarter saw the continuation of a common theme in 2022 and 2023 of public companies entertaining take-private offers from their private equity backers.

Target	Acquirer (if Any)	First Reported	Approximate Transaction Value ($M)	Stated TRA Liability at Last Filing Date ($M)	Settled TRA Value ($M)	TRA Status/Full Payment or Negotiated Value	Notes
HireRight	General Atlantic; Stone Point Capital	12/08/2023 (Announced)	TBD	210.5	TBD	TBD	▪ General Atlantic and Stone Point made a nonbinding proposal to acquire all of the company's outstanding shares of common stock that they do not already own at $12.75 per share.
Fathom	CORE Industrial	11/27/2023 (Announced)	TBD	25.8	TBD	TBD	▪ Fathom was acquired by CORE Industrial Partners in 2019 and taken public in 2021 in a de-SPAC. ▪ At the time of CORE's nonbinding proposal to reacquire Fathom, CORE held equity in Fathom, representing 63% of the company's outstanding voting power.
Sculptor Capital Management	rithm	11/17/2023	720	173.1	--	TRA Still in Effect	▪ Pursuant to the acquisition, Rithm agreed to a TRA guaranty, requiring Rithm to guarantee the founders will receive the full stated liability amount (~$173 million) from Sculptor/Rithm.
Hostess Brands	Smucker's	11/7/2023	5,600	124.1	85	Full Payment	▪ The obligation associated with the TRA is to be paid in cash by Smucker's following the completion of the merger.
Sunlight Financial	Sunstone Credit; Greenbacker Capital; cross river; igsenergy	10/31/2023 (Announced)	TBD	--	--	Payment Waived in Full	▪ On October 30, Sunlight Financial entered Chapter 11 bankruptcy and arranged to be sold to an industry consortium. ▪ Sunlight Financial listed its assets in the range of $100 million to $500 million, while liabilities were between $500 million and $1 billion.

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TRA Buybacks

On December 29, 2023, Vistra Corp. repurchased TRA rights from a selected group of registered holders.

TRA Issuer	Buyback Date	Crystallized Cash Flows at Last Filing Date ($M)	Settled TRA Value ($M)	Full Payment or Negotiated Value	Notes
VISTRA	12/29/2023	1,400	476	Negotiated Value	▪ The company repurchased approximately 68% and agreed to repurchase an additional 6% of the outstanding TRA rights in exchange for the issuance of Series C Preferred Stock. ▪ In connection with the repurchase, holders consent to certain TRA amendments related to information sharing, transferability, and defining a change of control.

UP-C STRUCTURE UNWINDS

- The umbrella partnership corporation (Up-C) structure provides several unique tax benefits for both pre-IPO and public owners by reducing future tax liabilities for the company and exit costs for pre-IPO owners.
- Despite these advantages, many companies in recent years have chosen to eliminate their Up-C structure in favor of a more streamlined, traditional C corporation structure.
- The transaction form taken when eliminating an Up-C largely determines whether the unwind is value accretive or dilutive for existing TRA holders.

Entities taxed as partnerships often adopt an Up-C structure concurrent to their IPO or de-SPAC business combination as a flexible, tax-efficient alternative to a traditional C corporation in which all shareholders hold their equity in the form of public company (PubCo) shares. The majority of PubCo TRAs outstanding were issued in connection with Up-C IPOs or de-SPAC business combinations. The Up-C structure is more costly to maintain than the C corporation alternative, and its benefits may be reduced as units are exchanged and more profits are subject to corporate income tax. Over time, a TRA holder should be prepared for the PubCo to “unwind” or “collapse” the two-tier Up-C structure and convert it to a full C corporation structure.

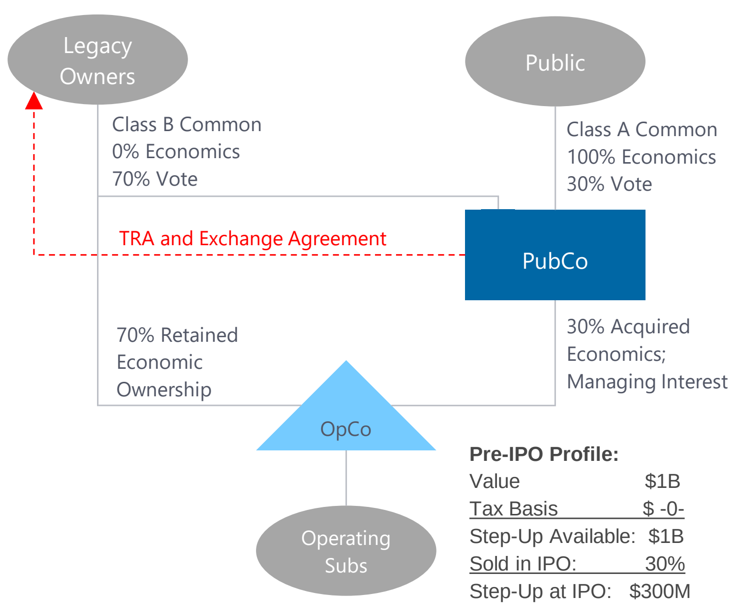
For TRA holders, the collapse of the Up-C structure may be value accretive or dilutive depending on, among other variables, the specific terms of the TRA, the transaction structure, and the current financial condition of the PubCo. We will focus on the most direct value driver—whether the collapse occurs in a tax-deferred or taxable manner.

The Up-C Structure (Briefly) Explained

The Up-C is a two-tiered structure in which a newly formed C corporation organized to serve as the PubCo is admitted as a new managing partner in an existing operating partnership (OpCo) by using the capital that it raises in the IPO to acquire an interest in the OpCo. See Figure 1.

Public investors own their voting and economic interests directly in the PubCo, while the pre-IPO owners (Legacy Owners) continue to hold interests directly in the OpCo. Legacy Owners maintain public liquidity in their investment via their negotiated right to periodically exchange their retained interests in the OpCo for an equivalent value of common stock in the PubCo. On such an exchange, the PubCo generally receives a tax basis step-up in its acquired portion of the OpCo assets, which creates ordinary deductions for depreciation, amortization, and imputed interest. These deductions reduce the PubCo’s cash tax obligations and serve as the primary tax benefit shared between Legacy Owners and the PubCo when the various parties execute a TRA.

Figure 1: Simplified Example of Up-C Structure at IPO



Reasons to Unwind

The shift to a full C corporation is often driven by a variety of factors, including changes in the corporate tax rate, strategic considerations, and a desire for simplification. The examples below highlight what a few companies specified as the rationale for their reorganizations.

PennyMac Financial Services, Inc.

Investor Presentation

August 2, 2018

"Key Implications [of Corporate Reorganization] for Existing… Stockholders

Simplified Corporate Structure:

- All equity holders will be represented by a single class of common stock.

Simplified Financial Reporting

- Eliminates allocation of income and equity between… common stockholders and… unitholders.
- More easily understood by investors and analysts, straightforward earnings and book value per share calculations.
- Greater comparability to most other publicly traded companies.

Expands Potential Investor Universe and Demand for the Stock

- Enables certain investors to own larger stockholdings where position limits are tied to percentages of companies' market capitalization.

Increases eligibility for inclusion in certain stock indices."

zoominfo

Press Release

September 7, 2021

"'This is an exciting next step in our evolution as a public company,' said Henry Schuck, ZoomInfo Founder and CEO. 'Just as removing complexity is good for our customers, it's also good for our investors. With this move to simplify our corporate structure, we further reinforce our commitment to good corporate governance, eliminating multiple share classes and giving all our shareholders one vote per share.'

The company believes that these changes will unlock shareholder value by expanding potential investor appeal through reduced complexity and more investor-friendly corporate governance. The restructuring is expected to enable the company to become eligible for inclusion in relevant stock indices. Operationally, the company expects the simplification to reduce compliance and reporting costs and increase cash flow, as well as increase flexibility with respect to future transactions and potential acquisitions."

PROFRAC

Investor Presentation

April 6, 2023

"Benefits of Up-C Structure Elimination

- Further align Wilks family with common shareholders, differentiating the company from peers that are retaining dual share class and could improve the likelihood of the stock being included in stock indices.
- Significant reduction in cash outflows in the event of an early termination of the company's TRA.
- Extinguishes $2.5 billion redeemable non-controlling interest previously reported on the company's balance sheet."

Four companies wound up their Up-C in 2023.(1)

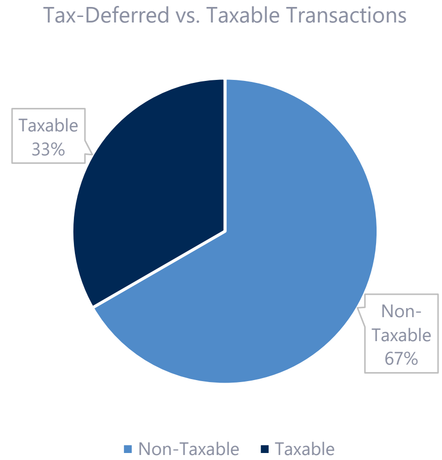
TRA Company	IPO Date to Transaction Date	Transaction Details	TRA Status/Full Payment or Negotiated Value	Notes
amneal PHARMACEUTICALS	Q2 2018–Q4 2023	Tax Free	TRA to Remain in Effect With Respect to Prior Transfers	▪ The reorganization purports to improve cash flow and transparency. ▪ Amneal intends to utilize its higher cash flow generation to pay down debt. ▪ Pursuant to the reorganization, the company also amended the TRA to reduce the company's future TRA obligations from 85% to 75% of tax benefits realized. ▪ The reorganization did not cause the acceleration of TRA payments.
bgc	Q4 1999–Q3 2023	Tax Free	TRA to Remain in Effect With Respect to Prior Transfers	▪ TRA was put in place in 2008 in connection with BGC's separation from Cantor Fitzgerald. ▪ Despite the long tenure of the obligation, no balance sheet liability was ever recorded. ▪ The reorganization did not cause the acceleration of TRA payments.
PROFRAC	Q2 2022–Q2 2023	Taxable	TRA to Remain in Effect With Respect to Prior Transfers	▪ The reorganization did not cause the acceleration of TRA payments.
LIBERTY	Q1 2018–Q1 2023	Taxable	TRA to Remain in Effect With Respect to Prior Transfers	▪ Class B shares were already ~99.5% sold down at the time that the LLC was merged into the PubCo. ▪ Pursuant to the merger, remaining LLC units were exchanged for Class A common stock in the PubCo. ▪ The reorganization did not cause the acceleration of TRA payments.

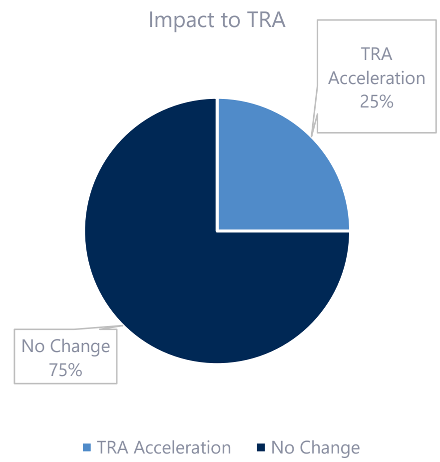
(1) This follows a similar trend from 2018–2019 when many financial institutions converted from an Up-PTP to an Up-C structure (e.g., Sculptor Management, Blackstone, Apollo, KKR, and Ares). Similarly, in 2020, Carlyle converted directly from an Up-PTP to a full C corporation structure. These conversions were likely prompted by the reduction of the corporate income tax rate from 35% to 21% pursuant to the Tax Cuts and Jobs Act of 2017.

Structuring Considerations: Tax-Deferred Transactions

In a study of 12 Up-C to full C corporation conversions since 2018 (excluding conversions pursuant to an acquisition of the PubCo by another company), eight out of 12 conversions were structured to be tax deferred, which means they did not trigger a gain to the Legacy Owners, nor did they result in significant incremental tax basis shifts to the New PubCo. See Figure 2 and Figure 3 below.

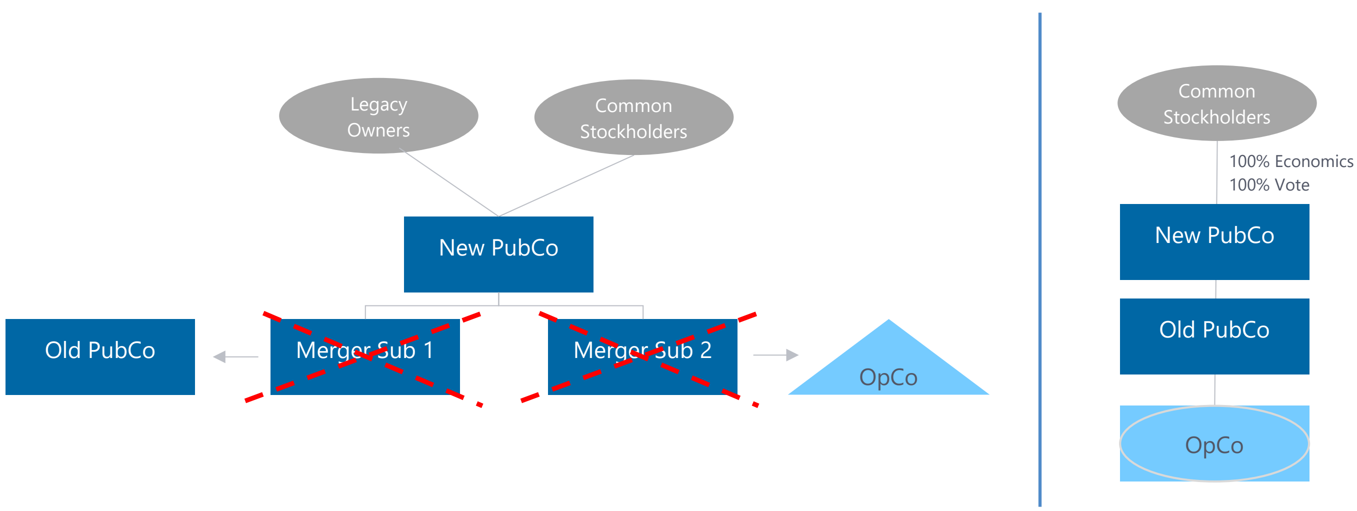
Figure 2 and Figure 3: Proportions of Unwinds by Transaction Form and TRA Acceleration Outcomes





In a tax-deferred conversion, Legacy Owners exchange their remaining units on a one-for-one basis with Class A shares. See the illustration in Figure 4 below for a typical tax-deferred unwind transaction. The exchanges do not result in an additional basis step-up, as the units are exchanged in a tax-deferred manner. Instead, Legacy Owners permanently surrender the uncrystallized value of their TRA rights (or at least traditionally, the vast majority of it),(2) resulting in two outcomes: (i) for TRA holders who had already exchanged units for stock of the public company, the value of these crystallized TRA rights is expected to increase; and (ii) for those who are exchanging on a tax-deferred basis in the Up-C conversion, the value of these uncrystallized TRA rights are significantly diminished or foregone entirely. Thus, with respect to crystallized rights, the taxable income of the OpCo is now 100% attributed to the New PubCo without a corresponding tax basis step-up. Therefore, the amortization deductions from previous step-ups are more likely to be absorbed by the New PubCo on an accelerated basis, increasing the likelihood and speed of payout.(3) For a tax asset investor who previously bought rights in crystallized TRA obligations of the public company, this is generally a positive development for the same reasons. In contrast, with respect to uncrystallized TRA rights, the exchanging shareholders relinquish their uncrystallized TRA rights in exchange for plain vanilla common stock in the PubCo. When those Class A shares are sold on exit, these exchanging shareholders will have taxable income without offsetting tax benefits from the TRA. In most cases, there will be significant overlap between these two classes of shareholders.

Figure 4: Illustrative Tax-Deferred Up-C Unwind Structure



(2) An increasing number of TRAs include some degree of historical basis as a specified asset. In these cases, a tax-deferred exchange would nevertheless result in an incremental increase in TRA value due to the carryover basis component.

(3) This analysis assumes that the unit exchanges do not result in a change of control that would cause an acceleration of the TRA, as when sufficient high vote stock held by controlling members is relinquished for single-vote common stock. In this case, TRA payments would nevertheless be treated as if they were exchanged in a taxable sale, and TRA-holder favorable valuation assumptions in the TRA would be operative, including, commonly, that the public company will have sufficient income to utilize the tax attributes and/or that the public company is subject to the maximum rate of tax. The TRA may, in certain circumstances, be amended to soften the impacts of a full TRA acceleration, such as by defining the transaction to be outside of the scope of the change of control provision in the TRA, lengthening the payment period, or otherwise waiving rights to accelerate the TRA.

Structuring Considerations: Taxable Exchanges

Taxable exchanges result in immediate tax consequences to the exchanging unitholders. In turn, the company can avail itself of a full basis step-up in the OpCo assets, including any remaining self-created goodwill. Future payments would continue to be matched with actual tax savings. See Figure 5 below for a table describing the implications of a taxable versus a tax-deferred conversion.

Because taxable exchanges crystallize the remaining value of the TRA, they can potentially increase the TRA liability considerably. The larger the TRA liability, the larger the drain on free cash flows, and the more likely it is that, in any given year, the company may not have sufficient taxable income to absorb the full benefit of the tax attributes, thus delaying the tenor of the payout.

Figure 5: Comparing Value Impact of Taxable vs. Tax-Deferred Unwinds

	Tax Deferred	Taxable
Basis Step-Up	No	Yes
Immediate Capital Gains Impact	No	Yes
Crystallized TRA Holder	Value Accretive	Value Dilutive
Uncrystallized TRA Holder	Value Dilutive	Value Accretive

Conclusion

The Up-C structure continues to be the dominant structure for flow-through entities to raise public capital. Nevertheless, external factors (such as tax rate changes) or internal factors (such as a continued decline in share price, high compliance costs, or a desire to list on other stock indices) may motivate certain public companies to unwind their Up-C. As described, a TRA holder should understand how the chosen structure of the unwind transaction may impact their investment.

HOW HOULIHAN LOKEY CAN HELP

TRAs represent a unique and growing asset class that provides a bridge in negotiations between buyers and sellers when tax assets are present. Houlihan Lokey's cross-functional team, with expertise spanning investment banking, tax, board advisory, and complex, illiquid financial instruments, can advise on a wide breadth of subject matters that arise in connection with originating, holding, transacting, or terminating a TRA. We are actively conversing with investors, TRA holders, and industry stakeholders to develop a secondary market for these unique assets. In addition, we provide independent advice and opinions of value to special committees, sponsors considering continuation vehicle transactions, and lenders or holders with respect to collateral value assessments. Finally, Houlihan Lokey can also provide compliance-driven valuations for financial and tax reporting purposes grounded in real market dynamics for TRAs.

If you have any feedback or questions, or if there is a TRA-related topic you'd like to see in future editions of this newsletter, please reach out to the TRA team at TRA@HL.com.

Want to see back issues and other TRA content? Visit us at HL.com/insights/tax-receivable-agreements/.

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