Voice Over:	00:00	Welcome to Trailblazing: Capitalizing on Tax Receivable Agreements, a Parallaxes Capital podcast that is here to guide you through the world of tax receivable agreements. It's time for Trailblazing.
Saish Setty:	00:14	Welcome everyone to another insightful episode of Trailblazing. I'm Saish Setty, general counsel of Parallaxes, and today we'll have a great conversation with Andy Lee, CIO of Parallaxes to discuss our predictions for 2024 in the world of tax receivable agreements. Welcome, Andy.
Andy Lee:	00:39	Hi, glad to be here.
Saish Setty:	00:39	So let's cut to the chase here. We've been doing this now for seven years at Parallaxes and with all that experience, where do you see TRAs going in 2024?
Andy Lee:	00:53	I think there are five items when we broke it down actually kind of surprised me as to some of the ultimate takeaways for the market. As we go into 2024, A number of them will be familiar to our listeners. However, some of the takeaways and as pertains to the underlying composition of them were definitely surprises to me. So shall we hit it?
Saish Setty:	01:13	Yeah, yeah. Do you want to take us through those five main items on a high level?
Andy Lee:	01:18	Absolutely. So number one, we believe that the absolute number of TRAs will shrink in 2024. Number two, despite that the absolute size of the TRA market measured by UPB will actually grow. The third point is that adoption of TRA technology wouldn't be from the mega funds, but more so from the middle market. Number four, the rise of non-op CTRAs will grow in popularity. And the fifth point is that we believe that capital formation in the sector will be challenged.
Saish Setty:	01:53	Got it. So let's start with that first prediction then the absolute number of TRAs will shrink. Do you mind maybe breaking down the reasons behind this prediction?
Andy Lee:	02:03	Yeah, absolutely. I think that many market participants would suggest that the large backlog of IPOs resulting from the lack thereof in 2022 and ‘23 would result in there being growth in the market. I think there are five factors that primarily drive our belief that TRA creation will be dwarfed by terminations. So let's hit them number one around TRA maturities. So these are payments or specifically final payments from the ‘23 tax year

that would ultimately result in the TRA being exhausted and terminated. This includes the likes of Surgery Partners or El Pollo Loco. Names that have been outstanding for a number of years. Two, is take privates. The rerating and correction in underlying stock prices. We've seen across our universe TRAs dropping in price since the end of ‘21 by approximately 40%. This rerating would likely result in potential boards of directors as well as management teams revisiting how they think about their strategy as it pertains to maximizing shareholder value.

03:29 We believe that remains a likely a strong sponsor bid that despite the lack of leverage will likely come to the fore, but also a strong strategic bid. We saw that in ‘23 with the likes of Hostess brands but also signify health. The third point is around liability management. In the highest interest rate environment, we saw a number of management teams undertake liability management transactions to simplify their balance sheets. This include the likes of Summit Materials, but also Vistra Energy. The fourth point is around bankruptcy. Not every business was meant to be a public business or already prepared to be public. A number of them were pushed into the public domains. Amiss the valuation uplift via SPAC bids and sponsors trying to take advantage of the valuation levels during covid to monetize portfolio companies. There has been a lack of public interest in those names and so many of them, to the extent that they are not cashflow break-even likely are going to struggle to raise new money and remain going concerns.

04:47 So we have about 15 of those names within our universe that we're focused on and that represents approximately a billion dollars of unpaid principal balance. I think the final point that I would make is tax-free exchanges. You've seen a number of them occur in the last year that includes the likes of an Amneal, a ProFrac, a BGC, and more recently Lazard. And so as we enter an election year, people who are tax sensitive, might that be founders or management team members may simply choose to forego the benefits of a TRA in a tax free exchange. Obviously to the extent the equity sits within non-taxable vehicles, might that be foundations, endowments, or IRAs among others that may be less of a concern, but that primarily is the reason why it informs our point of view, that TRA terminations in ‘24 likely will dwarf those of creations in this new year.

Saish Setty: 05:52 Yeah, and this is one of those predictions that I think is certainly going to take some individuals by surprise, especially a lot of market participants. But to your point, I mean TRA maturities take privates liability management transactions, BKs bankruptcies, tax-free exchanges, there are a lot of forces that are at play to bring down the absolute number of TRAs next year. And maybe moving on to the second prediction then, which is initially a bit contrasting to the first one is the absolute size of the TRA market in terms of principal balance is something that we expect to grow. So do you mind talking about that prediction as well, especially in contrast to the decrease in the absolute number of TRAs?

Andy Lee: 06:45 Absolutely. And why don't we tag team this one and you can hit the items for growth, but there are seven factors around why the TRA market is balanced between growth of unpaid principal balance, but also reduced by them. And so I'll hit them in turn *(a)* new IPOs, *(b)* secondary transactions, *(c)*, taxable exchanges which are balanced by TRA maturities, take privates, liability management transactions, but also bankruptcies. Do you want to take us through what we think is going to come with new IPOs?

Saish Setty: 07:23 Yeah, so in terms of where we see growth coming from the first point, new IPOs, frankly this is probably the one that doesn't take anybody by surprise. TRAs most commonly associated with the Up-C IPO. That said new IPOs themselves typically aren't the largest contributor to market size. And that's because when you look at how much of the business is initially floated in a public offering, it tends to be say 15 to 20%. But that said, the IPOs and growth in the IPO market will contribute to market size. The second aspect though secondary–

Andy Lee: 08:09 if you don't mind me just double clicking on that piece, on the new IPOs alongside what say you shared on 15 to 20% of a business being floated in an IPO, the other element to it is typically a sponsor would do an IPO as part of a de-levering transactions. One of the things that public market participants don't really like is heavily levered stories. And so oftentimes as part of going public, a sponsor would use the new equity contributed to pay down debt. And so oftentimes that's not additive from a growth of a TRA perspective.

Saish Setty: 08:48 Definitely. And I guess the second point then is secondary transactions. And I think we all agree that this is probably the biggest contributor to the growth of the TRA market. The idea here is that to actually crystallize your rights under the TRA, generally speaking, you have to sell out of your equity. Over the last year or two years, there's certainly been a lot of volatility in market prices, especially compared to the period before that. But as stock prices have stabilized, at least relative to this free fall, we've seen since 2021, sellers are probably going start accepting this new valuation norm, the new environment that they're in, and are probably going to be more open to monetizing the equity in the businesses that they had previously taken public. And that monetization will create new TRA effectively. And then the third point on growth here is the idea that you can have a taxable exchange, you can collapse the Up-C structure. This is a transaction that corporations will typically do to simplify their org structures. And in fairness, I think Andy, you agree here, this is relatively rare, but this is an example of a transaction where you really pave the way for market growth in the TRA because if you collapse your Up-C, you're effectively crystallizing the entirety of your TRA. And do you want to take us through the potential reductions, a lot of which I think we just covered in the first point?

Andy Lee: 10:40 Yeah, absolutely. So as previously discussed, the items that would result in market decline, that would be a TRA payment maturity from the most recent year. So that would be '23's tax year. Two would be take privates, three liability management transactions, and four bankruptcy. And we're constantly tracking them. Do you want to hit the point quickly on the lawsuits?

Saish Setty: 11:09 Yeah, so I think one thing that has really captured a lot of headlines, at least in the last few years are recent litigations that have been against companies that have repurchased their TRAs. In fairness, a lot of these transactions might, or at least the lawsuits describe them as self-dealing, but the fact that companies and corporate boards are more aware of this litigation risk, it's going to create some newfound caution around buyback transactions. So there's been a flurry of activity in the last five years, but a lot of that activity has resulted in bad press and I think we're going to be seeing companies be more careful about repurchasing their TRAs, in which case you probably see a little less termination activity on that front at least.

Andy Lee: 12:09 Absolutely. So look, we're incredibly bullish on the growth of the market. The bankruptcies that we discussed those would primarily generate during the SPAC boom and obviously subsequent decline, but they never generated a meaningful amount of unpaid principle balance to grow the absolute market size by dollar. And so that said, one of the items that's helpful is that many venture capital as well as growth equity firms were recipients of TRA and we believe they are going to be a big part of driving the growth and adoption of TRAs in their future portfolio companies that go public as a result of now realizing that money is going to be left on the table.

Saish Setty: 12:55 And I think this ties in though to our third prediction. This is one that if you've been following the TRA market since the very beginning, is probably amongst the more surprising predictions. And that's this idea that TRA adoption, TRA growth, is going to start coming from the middle market versus the mega funds. And if you think back to the history of TRAs amongst the earliest ones where Blackstone, Apollo, they use them in their own IPOs. So what's driving this surprising shift in your mind?

Andy Lee: 13:34 Absolutely. So there are two items that primarily drive that. So one is around the inflation reduction act that was passed in 2022. So, the inflation reduction act brought with it what is known as the corporate alternative minimum tax that has language around the fact that and the way that we and our stakeholders in the ecosystem have been thinking about it, it has the potential of the firm, what would otherwise be a 15-year asset for an extended period of time. What that really does is it materially reduces the NPV of a tax asset. If you think about the validity as well as efficacy of a TRA, that might not be the worst thing in the world. And so far that sponsors are fundamentally taking the point of view that the public markets don't believe that they value tax assets appropriately. And so that's still money being left on the table.

14:36 So in my mind, that's the less nefarious version of what's going to prevent market growth. And really that only applies to companies with what is known as average financial statement income of more than a billion dollars over a trailing three-year period. As we look at the market that really only implicates four TRAs today representing across about 3 billion of face value, the one that's more nefarious is what was passed in the OECD around what is known as pillar two. So the point of pillar two is to reduce incentives from multinational companies around tax planning as and more specifically avoidance by allowing companies, preventing companies from choosing to pay taxes in jurisdictions that have lower tax rates. So this applies to companies with more than 750 million euros in revenues. So think about it almost like a billion dollars US dollars. And this has the potential to permanently impact the size of TRAs and diminish the savings associated with those underlying attributes. And as we size it and the impact on the market that implicates call it 44 TRAs, which currently represented call it 13 billion dollars in face,

Saish Setty: 15:56 Ultimately it sounds like when we're talking about corporate alternative minimum tax pillar two, these are negatives for a company's TRA, but it really only impacts companies over these size thresholds. So it sounds like that's why we think the mega funds are going to be less incentivized to use TRAs, but anticipate this to still be extremely active from the middle markets perspective just based on the size of the companies they deal with.

Andy Lee: 16:27 Absolutely.

Saish Setty: 16:28 Again, I guess tying this in, so we were talking about how we see growth in the middle market, what about the fourth prediction then? So historically TRAs have been tied to the Up-C IPO, we're talking about seeing this more often in middle market, middle market private equity backed companies. How do you see this growing past the Up-C IPO though?

Andy Lee: 16:53 Look, non-Up-C TRAs today represent sub 5% of the total market, and in fairness have been a rarity in the last five years. I think as more sponsors have picked up on the value of TRAs they're looking for in an environment where they're trying to maximize dollars for their underlying stakeholders, i.e. LPs, they're looking for avenues to increase value and tax assets remain a forefront where it's been, we are somewhat only in the first inning as it pertains to monetization of tax assets. So other tax assets that people have monetized in the past, might that be the things such as a net operating loss, interest deduction carry forwards that were created it from TJCA, but also other tax assets might that be long-term incentive plans existing basis among others. These are significant sources of value and they were primarily generated in the '22 to '23 downturn. And so we expect sponsors to really lean into that vector for growth in the market.

Saish Setty: 18:02 Yeah, and you even see some TRAs of this ilk that include things like the deductions that are available due to IPO expenses. And this is a prediction that I almost feel as though it's inevitable. I mean you mentioned it, we always talk about TRAs being valuable because public markets are indifferent or they're agnostic to the value of tax assets. So in theory, it shouldn't really matter if those tax assets stem from the Up-C IPO or really any other context. And it feels like the market is starting to move in that direction now.

Andy Lee: 18:44 Yeah, I would definitely say that anecdotally the conversations that we have as to avenues for sponsors to create TRAs away from the Up-C have increased both from a quantum perspective but also the frequency.

Saish Setty: 18:58 And so let's move on to the final prediction then. It's the idea that capital formation in the sector will be hurt. And part of what's driving this is, I mean from our experience we've seen a number of visitors or tourists in the sector if you want to call it that, and we just talked about how the TRA activity of the last few years has made people more aware of this. If you're a VC or a middle market private equity fund, you might be more incentivized or you better have a better understanding of TRAs. You're more incentivized to put them in your structures. On the flip side though, it sounds like there's more interest in the space, there's more awareness of the space, which is bringing in more investors, but curious to hear your thoughts on why you think that'll actually hurt capital formation around the opportunity.

Andy Lee: [19:56] Yeah, absolutely. I think from a supply side of the equation on the capital side, that has been significant interest, primarily driven by the fact that in a high base rate environment, firms with underlying stakeholders that include insurance platforms are very much looking for long duration assets and looking to lock in those yields for a long duration and they find this TRAs to be able to deliver that. Exactly. That said, many of these ”tourists” or visitors are ill-equipped to underwrite TRAs and many of them are who are looking at this space are primarily leaning on their relationships with sponsor clients via the direct lending platform among others. And so our big concern there is that these firms may potentially get burned as a result of underwriting misses and inevitably portray the industry as un-investable to their investors as part of trying to lay blame somewhere else.

[21:03] So what are some of the industries that a first time in the sector miss from an underwriting perspective? I think where we see them missing the most is the fact that most direct lending platforms are very focused on two items. One, having a significant equity cushion and two, underwriting a medium-term maturity that is five to seven years. So the problem for TRAs is that many of them may have the ability to defer a payment indefinitely while still maintaining healthy equity, but also debt relationships. They also suffer from impairment risk, which may stem from items such as foreign derived intangible income, foreign tax credits, and even the potential application that we hit on earlier, that being pillar two. So as we think about them, there is incremental complexity that is not well understood from potential buyers in the space that may result in them not necessarily understanding fully what they're purchasing.

Saish Setty: [22:23] And on the equity cushion point, I think that's very fair because it feels like you're often in an environment where you have direct lenders that are investing in sponsor backed companies. Equity cushions have certainly grown quite a bit, especially in the portion of the deal that's equity. The amount of leverage that's in there has changed quite a bit versus what you'd see say 20 years ago. And it often feels like a lot of lenders just assume that sponsors will be incentivized to protect their equity and support the portfolio company, whether that's through equity injections or through other avenues. But what makes TRAs interesting on some level too is that unlike a pure debt investment, you're not in a situation where weakness in the TRA indicates that there's weakness on the equity. So it sounds like it's fair to say that your incentives aren't necessarily a hundred percent aligned there. Right.

Andy Lee: 23:28 You had it.

Saish Setty: 23:29 Great. And on this point though of tourists too, I mean we've talked about how institutional investors often view TRAs as the next frontier of investments. Hopefully, we're at the forefront of that. I think if you're on the outside looking in on TRAs, this is going to remind folks of pharma royalties in the 2000s, music royalties in the 2010s, and both of these sectors saw significant capital enter the space and then subsequently leave. I mean pharma royalties, you have the situation where royalty pharma was able to fight off a number of other entrants to eventually claim leadership of the sector. The jury is still probably out on musical royalties, but let me know if you think about this any differently, but this is probably the same story in TRAs that's played out a number of times in the past.

Andy Lee: 24:31 Absolutely. Look, our job is to be stewards as the industry leader of a fast but yet young market. And as we think about bad actors in the space, might that be some of the lawsuits that have been undertaken. Our job is to safeguard the industry and ultimately standardize some of the aspects of it in order to ensure that what was otherwise once a cottage industry ultimately grows and blossoms to being what we believe the true potential to be. And so we're excited for what ‘24 has in store and looking forward to engage with the various stakeholders as we share some of our predictions. We are happy to be proven wrong on a number of fronts. Might that be growth of the number of TRAs that are out there and we're excited for some of the likely innovations that might arise in time.

Saish Setty: 25:27 Definitely. And ultimately, hope everyone is then very excited to tune in a year from now when we look back and recap all these predictions with the benefit of hindsight.

Andy Lee:	25:37	Yeah, look, I mean the one thing that might throw an issue into the works is the upcoming election. One of the things that you and I have been tossing around is the potential for us to bring on almost like a pundit of sorts to give us the perspectives as to where Republicans might be, should their candidate be elected, but also the Democrats just hearing where everyone is from a tax perspective and where that sits on their agenda and what they might prioritize going into a new presidential candidate.
Saish Setty:	26:09	And talk about examples of maybe risk factors that tourists aren't necessarily underwriting
Andy Lee:	26:16	A hundred percent looking forward to the discussion.
Saish Setty:	26:19	Great. Well thank you Andy. Thank you to our listeners. As always,
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