



## FEATURE: VALUATIONS

By **Daniel M. Kerrigan** & **Todd G. Povlich**

# Carried Interest Planning—From Structure to Valuation

A core concept in estate planning is gifting or selling those assets with the greatest growth potential

**A**s has been widely chronicled, the increase in asset allocations to hedge and private equity funds by individuals and institutions has been significant for the better part of two decades. With global assets under management (AUM) estimated to be in excess of \$125 trillion, the allocation to alternative investments is estimated to be at least \$10 trillion.<sup>1</sup> Within that category, industry data indicate that over \$5 trillion is invested in hedge and private equity funds globally. Other alternative investments include real estate, commodities, infrastructure and structured products.

With this growth trend has come a host of opportunities for estate planners and their clients. A core concept in estate planning for ultra-high-net-worth individuals and families continues to be gifting or selling those assets with the greatest growth potential. Aside from certain venture capital investments, there may be no asset with greater growth or cash flow potential than carried interest. And, with new firm launches and fund formations a constant in the industry, the planning opportunities come frequently.

### What’s “Carried Interest”?

The term “carried interest” has roots dating back to the 16th century, when medieval merchants in Italy carried cargo by ship for customers and earned 20 percent of the ultimate profits on the carried product.<sup>2</sup> The merchants took on the risk of the voyage with the knowledge that

their reward on the other side was a share of the profits.

Today, carried interest is the widely used phrase to describe the dominant incentive mechanism for general partners (GPs) and managing members of hedge funds, private equity vehicles and venture capital firms. In real estate, credit and other areas, the concept is the same but may be referred to as “promote” or “override.” In these various firms, the investment advisor or an affiliated entity (for example, the GP), pursuant to the fund agreement, is entitled to share in the total profits generated for its investors, if any. The most common rate in private equity is 20 percent of profits. Private equity and venture capital funds often include a hurdle rate (typically 7 percent to 8 percent), meaning the GP doesn’t receive carried interest distributions unless the limited partners (LPs) have received a full return of capital plus a preferred return on that capital. A newer and growing practice in the hedge fund industry is the use of a bogey, possibly based on the London Interbank Offered Rate or an index, with the idea that the manager ought to get paid based on alpha (or returns in excess of said bogey) rather than total return. Most hedge fund structures provide for incentive allocations to the manager equal to 15 percent to 20 percent of profits, but subject to a high water mark.

### The Valuation Question

There are few assets we come across that are subject to more valuation debate than carried interest. Imagine a carried interest in a newly formed private equity fund that’s seeking \$800 million in commitments, had just one closing thus far for \$300 million and has yet to make any capital calls. Let’s presume that the fund will be targeting controlling equity investments in turnaround situations within the middle market. Initial valuation issues include the ultimate size of the fund, the timing of investments and the potential investment return.

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Some would argue that nothing has happened yet with this fund, so how can the carried interest be worth anything other than zero? For the sake of discussion, let's assume that in the aforementioned case, we have professional asset managers with both relevant expertise and experience. In many ways, one should liken the carried interest to a deep, out-of-the-money call option or an option that bears a strike price well above the market price of the underlying asset. As of that instant in time, said option couldn't be exercised profitably. However, it still has value because, over the term of the option, there's some probability that the underlying asset value will rise sufficiently for the call option to be in-the-money, making some future exercise potentially profitable. For this reason, the call option in the foregoing example is said to possess time and volatility value. Carried interest functions in a similar way.

### Valuation Approaches

Continuing with the thought above, a logical next step might be to launch your option model software and apply the Black-Scholes option pricing model to value the carried interest. (Fisher Black and Myron Scholes developed an expression for the theoretical current value of a call option on a common stock.) In certain cases, this may be appropriate. However, there are a litany of other issues in the example above that can't be accounted for by the Black-Scholes option pricing model, so you must also consider other approaches. The output of an option model is impacted significantly by the time and volatility inputs. An option model may not provide the opportunity to account for unique factors and uncertainties (for example, in the hedge fund industry, the risk of failure and the uncertainty of future AUM) that are often present in carried interest valuations.

Generally, there are three methods that should be considered when presented with a carried interest valuation project: (1) discounted cash flow (DCF); (2) option pricing; and (3) comparable company. In some cases, only one of these techniques will be appropriate, while in others, it may be best to use multiple approaches and weigh the indications of value from each.

### DCF

The best approach is typically the DCF method. The DCF is an income-oriented approach based on the principle of anticipation. That is, the value of any asset is the present value of its projected cash flows, when the present value is computed using an appropriate risk-adjusted

discount rate. For carried interest in a private equity fund, the DCF method provides complete flexibility to account for the uncertainties of fundraising, the timing of capital calls, investments and exits, potential investment returns, waterfall provisions, fee waivers/offsets and fund expenses, among others. For a hedge fund, we can incorporate new capital, distinct fee classes, hurdle rates (if any), loss carryforwards, capacity constraints, fund fees and expenses and the highly probable outcome of alpha decay.

In addition, within the DCF approach, we can develop and employ multiple scenarios through either a simple multi-case approach or a more sophisticated Monte Carlo analysis (that is, a probability simulation used to analyze random phenomena, such as market returns,

The IRS issued proposed rules that might reduce a private equity firm's ability to use management fee waiver mechanisms to gain tax efficiencies.

understand the impact of risk and uncertainty in forecasting and as an alternative to using straight-line forecasting for uncertain variables). A multi-case approach is often incredibly helpful in early stage funds where uncertainty exists around almost every corner. Monte Carlo analysis can further enhance the valuation process. This technique can be especially helpful for funds with strategies that tend to generate highly variable or binary outcomes (for example, short biased, contrarian or rainy day strategies).

### Option Model

An option model is an elegant method to value carried interest due in part to its simplicity. As earlier discussed, in a private equity context, carried interest can be likened to an out-of-the-money call option in that incentive allocations are only available to the GP of the fund after the LPs have received a return of capital and a preferred return on that capital. Let's imagine a simple scenario in which a GP is entitled to an incentive allocation on one portfolio company investment, "PCI Corp."



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If it can be reasonably predicted that PCI Corp. will be held for a period of, say, four years and that the volatility of this company can be estimated by reference to comparable publicly listed companies, the Black-Scholes option pricing model could be useful. On the other hand, sometimes the results of such an approach can be counterintuitive. The value of an option is positively correlated with volatility; that is, the higher the volatility of the underlying security, the greater the option value and vice versa. One can imagine that, in assessing the carried interest on a highly speculative investment, such

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interest may not necessarily be more attractive or have more value than carried interest on an otherwise less risky investment.

### Market Multiples

Finally, there may also be cases suitable for a market-based approach, such as those in which the valuation project encompasses both the carried interest and management fee components of the business. There are over a dozen alternative asset management firms that are publicly traded today, and there's some data on merger and acquisition transactions that can be useful. Multiples of revenues, earnings before interest, taxes, depreciation and amortization<sup>3</sup> and AUM<sup>4</sup> can be observed from both public markets and private transactions. "Historical Market Data," p. 38, is a cursory summary of historical market data that we've observed.<sup>5</sup>

Before relying on the market approach, it's important to note:

- M&A transactions in this industry often include significant earn-outs given the dependence on key people and to incentivize the management team to remain in place. Information limitations often prevent a meaningful analysis of the impact of earn-outs on implied valuations and multiples.
- These multiples reflect prices paid for entire firms or minority shares of entire firms and, therefore, incorporate management fees and carried interest. There remains no standalone market indicator for the valuation multiple appropriate for carried interest cash flows, but one can reasonably estimate that such multiple is lower than the multiple appropriate for management fee cash flows. On the other hand, for those firms that make little or no net cash flow from management fees, one can argue that the firm multiple and the carried interest multiple are one and the same.
- The market approach is best suited for large, established firms with little or no key person risk, numerous investment products and many sources of investor capital.

It's also worthwhile to list some of the many risk factors and considerations that inevitably drive valuation multiples, discount rates and approaches, which may include:

- Track record of the management team/firm;
- Risk characteristics of the underlying investment strategy;
- Survival rates/term risk;
- Key person risk;
- Taxes on fee income and incentive income;
- Investment terms, including fees, liquidity provisions, waterfall structures, hurdle rates and high water marks; and
- Sector, strategy and country-specific risks.

### Unique Considerations

Going hand in hand with carried interest transfers is the concept of the vertical slice. Internal Revenue Code Section 2701 contains a series of special valuation rules that must be applied when determining the value of junior equity interests in entities transferred to family members. These rules came about in the wake of perceived abuses of preferred freeze partnerships and to



replace the overly onerous IRC Section 2036(c). While Section 2701 didn't appear to be targeted at carried interest transfers, it's been widely interpreted that carried interest is a form of junior equity and must be valued within the confines of Section 2701. This interpretation came about because fund principals often have capital interests alongside the other limited partners in the fund. These interests aren't always selected for estate-planning transfers because they have less appreciation potential than carried interest. In the Section 2701 analysis, these assets might fit the description of senior equity.

More specifically, Section 2701 calls for the junior equity to be valued using the "subtraction method." This method requires the value of the junior equity to be determined by subtracting the value of the senior interests. On its face, this method isn't problematic. But Section 2701 goes further, requiring special valuation rules for any of the senior interests that are applicable retained interests. Applicable retained interests that are

classified as extraordinary payment rights or distribution rights shall be valued at zero, potentially giving rise to a larger value for the junior equity than anticipated and a much larger gift than intended.

Section 2701 then outlines several exceptions to the application of the special valuation rules. The rules don't apply if:

- (1) There are readily available market quotations for the transferred or retained interests;
- (2) The retained interest is of the same class of equity as the transferred interest, or the retained interest is of a class that's proportional to the class of the transferred interest; or
- (3) The transfer includes a proportionate reduction of each class of equity interest held by the transferor (this is the vertical slice exception).

Therefore, if a fund principal is seeking to transfer

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his carried interest and has a capital (LP) interest in the fund, many estate-planning attorneys believe the vertical slice transfer is the best way, or at least the most elegant and straightforward way, of avoiding the application of the special valuation rules under Section 2701. To that end, we often see private equity fund principals, for example, transferring an equivalent percentage of their capital and carried interests to satisfy one of the exceptions to the application of such rules.

If a fund principal decides to use the vertical slice approach, it's important to identify each of the assets that such fund principal owns. He could own as many as four types of interests in, or related to, an underlying fund:

(1) **Capital interest** (either as a direct LP in the fund or as an indirect partner through the GP entity and capital account).

(2) **Management fee interest.** The fund principal usually owns all or a portion of the equity of the investment advisor, which is entitled to management fees from the funds and incurs expenses associated with fund management.

(3) **Deemed capital** (also referred to as "fee offset," "synthetic capital," "incentive capital" or "the management profits interest"). In private equity, it's common to see capital commitments satisfied through management fee waivers. Should the fund be profitable, this could convert ordinary income into capital gains income. However, if the fund can't first return all of the LPs' contributed capital, then pursuant to the fund agreement, distributions with respect to deemed capital typically aren't permitted (that is, there could be zero return). As stated below, the IRS is seeking to limit the use of management fee waivers.

(4) **Carried interest.** A share of the profits on LP capital, if any, subject to a hurdle, high water mark and/or clawback.

As we were finalizing this article, the IRS issued proposed rules that might reduce a private equity firm's ability to use management fee waiver mechanisms to gain tax efficiencies.<sup>6</sup> As stated in the proposal,

... the most important factor in determining

### Historical Market Data

*Alternative asset management industry and asset managers*

#### Major Transaction Activity: Alternative Asset Management Industry

Range of Enterprise Value to AUM Multiples, Excluding Outliers:	1% to 12%
Trimmed Range of EV to AUM Multiples (Middle 50%):	3% to 9%

#### Historical Multiples Observed for Publicly Listed Alternative Asset Managers

Range of Enterprise Value to AUM Multiples, Excluding Outliers:	4% to 15%
Range of Enterprise Value to Revenue Multiples, Excluding Outliers:	2x to 5x
Range of Enterprise Value to EBITDA Multiples, Excluding Outliers:	4x to 10x

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whether or not an arrangement constitutes a payment for services is that the allocation and distribution is subject to significant entrepreneurial risk... Under the proposed regulations, an arrangement that lacks significant entrepreneurial risk constitutes a disguised payment for services. An arrangement in which allocations and distributions to the service provider are subject to significant entrepreneurial risk will generally be recognized as a distributive share but the ultimate determination depends on the totality of the facts and circumstances...

### Alternative Transfer Techniques

While use of the vertical slice transfer is most common, there are other techniques that may be appropriate to consider. Several years ago, in "Using Derivatives to 'Transfer' Carried Interests in Private Equity, LBO and Venture Capital Funds,"<sup>7</sup> attorneys David A. Handler and Angelo F. Tiesi suggested that an alternative to the vertical slice approach is the use of a derivative or contract tied to the performance of the carried interest. Handler and Tiesi make the valid point that carried interest (particularly in a private equity fund) is a transitory asset that may produce cash flow for a defined period of time and then have zero value at the end of that period. It's therefore the transfer of the economics associated with the carried interest that's more important than transferring the actual asset, which will have zero terminal value at the end of a fund's life.



The derivative concept can be summarized as follows:


- The fund principal enters into a derivative contract with a trust for the benefit of children.
- The contract states that the fund principal is required to pay the trust, at a specified future date, the difference between: (1) the sum of the total carried interest distributions since fund inception and the market value of the carried interest at that future date, and (2) either zero or a hurdle amount (think strike price).
- The contract calls for a cash settlement on the earlier of: (1) the contract's stated expiration date, or (2) the fund principal's death.
- At the inception of the contract, the trust pays the fund principal for its rights under the contract. The purchase price is determined by an appraiser, who first values the carried interest and then values what effectively amounts to an at-the-money or out-of-the-money European call option on the carried interest. A higher hurdle amount would generate a lower purchase price, all other factors held constant, but also reduce upside to the trust.
- When the contract reaches its termination date, and if the fund has performed well, a cash payment is owed to the trust, and the fund principal retains the carried interest asset.

In "Going Non-Vertical With Fund Interests,"<sup>8</sup> attorneys N. Todd Angkatavanich and David A. Stein illustrate several approaches that may exist for fund principals that should satisfy other (non-vertical) exceptions within Section 2701. First, Angkatavanich and Stein suggest that the fund principal contribute both capital and carried interests into a limited partnership and, in return, take back preferred and common units in said partnership. The limited partnership resembles a classic preferred freeze partnership, with the senior equity entitled to a qualified payment right. A qualified payment right is a right to any periodic dividend on any cumulative preferred stock to the extent such dividend is calculated at a fixed rate. A qualified payment must be paid within four years after its due date, although it can be paid with a note with a maturity of up to four years. A critical element to this approach is hiring a business appraiser to set the appropriate preferred rate so that the preferred equity is worth its par value. Given the freeze technique, combined with relatively low preferred yields

in today's financial markets, one can see the potential benefits of this structure. Care should also be taken to ensure that the junior equity accounts for at least 10 percent of the total equity of the entity, in line with the minimum value rule under Section 2701.

There are also variations of the above approach put forth by Angkatavanich and Stein, one of which includes a mandatory payment right. Another approach calls for the fund principal to sell his LP interests to the same freeze partnership in exchange for a promissory note. Gifts of common units in the partnership are then made to a trust. Angkatavanich and Stein argue that because Section 2701 only applies to related equity interests and not debt, the special valuation rules of Section 2701 shouldn't apply, and the 10 percent minimum value rule should also be out of play.

### Final Thoughts

When it comes to estate planning with carried interest, fund principals are wise to choose their advisors carefully. It's recommended that fund principals take extra time at the front-end to communicate their intentions, coordinate the process and understand the potential strategies and results. Fund principals can own as many as four distinct interests in an underlying fund, and there may be more than one technique by which to effectively structure a transaction and comply with Section 2701. It will also be interesting to see if the proposed rules impacting deemed capital and management fee waiver mechanisms are adopted and what the ramifications of such rules might be. 

### Endnotes

1. Hedge Fund Research, Inc.; TheCityUK; Preqin.
2. James M. Kocis, James C. Bachman IV, Austin M. Long III and Craig J. Nickels, *Inside Private Equity: The Investor's Handbook* (April 20, 2009).
3. Earnings before interest, taxes, depreciation and amortization.
4. The focus is often on fee-paying assets under management.
5. Multiples were computed based on data obtained from company press releases, company filings with the Securities and Exchange Commission through the "EDGAR" database, S&P Capital IQ and Bloomberg Professional.
6. Federal Register, Vol. 80, No. 141 (July 23, 2015).
7. David A. Handler and Angelo F. Tiesi, "Using Derivatives to 'Transfer' Carried Interests in Private Equity, LBO and Venture Capital Funds," *Venture Capital Review*, Issue 17 (Spring 2006).
8. N. Todd Angkatavanich and David A. Stein, "Going Non-Vertical With Fund Interests," *Trusts & Estates* (November 2010), at p. 22.