



Successfully Navigating Sophisticated Financial Solutions



WELCOME

ESTATE PLANNING FOR
PRIVATE EQUITY / HEDGE FUND
CARRIED & PROFIT INTERESTS

PHIL STRASSLER ~ MODERATOR

October 5, 2011

8:00am Breakfast ~ 8:30am Presentations ~ 10:30am Conclusion



Nick Bertha

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Scott Nammacher

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N. Todd Angkatavanich
Partner
Withers Bergman, LLP

Todd's practice at Withers Bergman is focused on estate planning and business succession matters for affluent individuals and their families including planning for the transfer of fund carried interests into multi-generational trust structures.

Todd is the co-author of an article entitled "Going 'Non-Vertical' With Fund Interests - Creative Carried Interest Transfer Planning: When the "Vertical Slice" Won't Cut It," which formulated a number of cutting-edge approaches to structuring the transfer of carried interests beyond the so-called "Vertical Slice Rule."

In addition, Todd frequently publishes articles in the area of wealth planning and is a member of the Editorial Advisory Board of Trusts and Estates Magazine.

Nicholas J. Bertha III
Managing Director
Fieldpoint Private Bank & Trust

Nick has expert level capability in tax law, wealth transfer, and trusts & estates.

His extensive career, spanning over 30 years, includes prominent positions at Credit Suisse, DLJ and US Trust Company, where he led the Financial Counseling Group for many years.

At Fieldpoint Private, Nick is instrumental in assisting ultra high net worth families manage generational wealth. Nick's experience and legal background is a value added for Members on complex estate and income tax issues. Nick manages the innovative and flexible Trust business at the firm.

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**Robert Harrison, CPA
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Robert has been a Tax Partner at Eisner Amper for over 30 years and has extensive experience handling all areas of federal and state taxation, from both planning and compliance perspectives.

Bob provides tax research and planning for individuals, estates, trusts, private foundations, partnerships, limited liability companies and corporations. He concentrates in estate planning and the administration of estates and trusts as well.

Bob has authored many articles published in professional and general publications, and he provides executive review of the firm's tax guides, newsletters and tax memoranda.

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**Scott A. Nammacher, ASA, CFA
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Scott has over 25 years of valuation experience involving all kinds of business, intangible and financial asset interests.

Scott has been heavily involved in valuing carried and profits interests (including derivatives related to these interests) in P/E and hedge funds for the last eight years or so.

He has lectured at the local and national level on valuing these interests and their related management entities.

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- **What is the best strategy to gift your carried interest participations to your children?**
- **What are the various approaches and alternatives to using the “vertical slice technique?”**
- **What methods are used to value carried & profit interests?**





Successfully Navigating Sophisticated Financial Solutions



NICK BERTHA

**MANAGING DIRECTOR
FIELDPOINT PRIVATE BANK & TRUST**



FIELDPOINT PRIVATE BANK & TRUST[®]



Nick Bertha

Managing Director

Fieldpoint Private Bank & Trust

The Problem, The Opportunity
How to Get There From Here

The Main Idea

*“The Federal Estate Tax Is
A Voluntary Tax You Can
Pay It or Plan Around It!”*

Professor O’Leary

Nature of the Problem

- Carried/Profit Interests Can Appreciate Significantly Over Time – Lower Values at Inception and the Early Years
- Estate & Gift Tax Rates Currently *Low* at 35%
- Exemptions *High* at \$5mm per Person \$10mm per Couple
- This Will Likely Change at *Least* after 2012 When the Bush Tax Cuts Are Scheduled to Expire
- Possible Scenario: Top Rate 45% - Exemptions at \$3.5mm
- Clawback is Considered Unlikely

The Opportunity

- High Exemptions, Low Tax Rates Create a Window of Opportunity
- As They Say in Chicago: *Gift Early & Often* –
 - Transfer Assets & Future Appreciation Out of Your Estate at the Lowest Possible Valuation, to Those Who Would Eventually Receive Them Anyway
- Save *Substantial* Amounts of Estate Tax Otherwise Payable in the Future
- Shelters Assets from Possible Future Creditors

Gift Carried Interest Now vs. Later

Assumptions:

Initial Valuation: \$1mm

Fund Life: 8 years

Estate Tax Due: 30 yrs after End of Fund Life

Interest Appreciation Multiple: 10x

Stays In Estate – No Gift

After 25% Capital Gain Tax: $\$10\text{mm} \times 75\% = \7.5mm

Compounds for 30 yrs at 6% after tax = \$43,076,184

Available to Heirs After

Death Taxes 50% = \$21,538,092

Gift Carried Interest Now vs. Later

Assumptions:

Initial Valuation: \$1mm

Fund Life: 8 years

Estate Tax Due: na

Appreciation Multiple : 10x

*Current Gift to a Trust for Children's Benefit
– Out of Estate–*

After 25% Capital Gain Tax: $\$10\text{mm} \times 75\% = \7.5mm
Compounds for 30 yrs at 6% after tax = $\$43,076,183.80$

Death Taxes = \$0

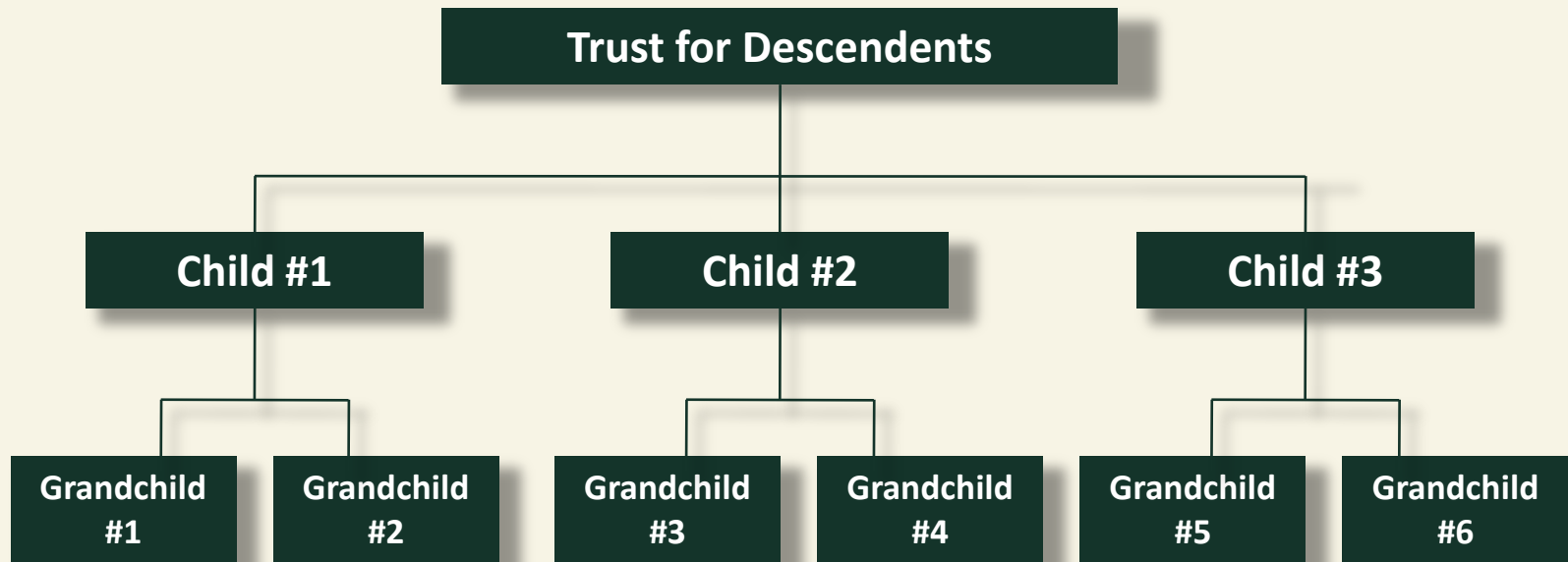
Available to Heirs = \$43,076,183.80

Economic Advantage: \$21mm+

Dynasty Trust

Dynasty Trusts

Combining the increased GST exemption with an early gift to an irrevocable trust creates the opportunity to make multi-generational gifts. Currently up to \$10mm per married couple which can continue in trust in perpetuity.



Dynasty Trust

\$10M Dynasty Trust vs. 35% Estate Tax Every 30 yrs

After Tax Growth	Value of Dynasty Trust After 120 Years	Value of Property if No Trust
4.00%	\$1,100,000,000	\$190,000,000
6.00%	\$10,880,000,000	\$1,940,000,000
8.00%	\$102,520,000,000	\$18,300,000,000
10.00%	\$927,090,000,000	\$165,490,000,000

Nothing's Perfect

- Vesting – If so, May Not be a Completed Gift Until Vested – Could Result in Higher Valuation
- Phantom Income to Gift Recipients
- Transferee Capital Call – (Vertical Slice)
- Clawback
- Must File Gift Tax Return – Need Appraisal
- Gift is Irrevocable

The Narrative

- The Problem & The Opportunity
 - *Nick Bertha*
- The Complexity of Making the Gift
 - The Standard/Adequate Solution : “Vertical Slice”
 - More Advanced/More Attractive Solutions: “Going Non-Vertical”
 - **Todd Angkatavanich**
- Tax Effective Transfer Techniques: 101 & Beyond: GRATS
 - Defective Grantor Trusts
 - Derivatives & More
 - *Robert Harrison*
- But What’s It Worth: Valuation -The Secret Sauce!
 - *Scott Nammacher*

Goal

- Have a Sense of What's Possible
- Understand Your Options
- Learn Where the Creative Horizon Is



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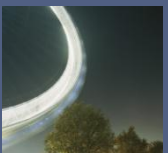
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Estate Planning Strategies for Private Equity and Hedge Fund Partners with Carried Interests

October 5, 2011

Presented by:
Withers Bergman LLP
N. Todd Angkatavanich, Partner

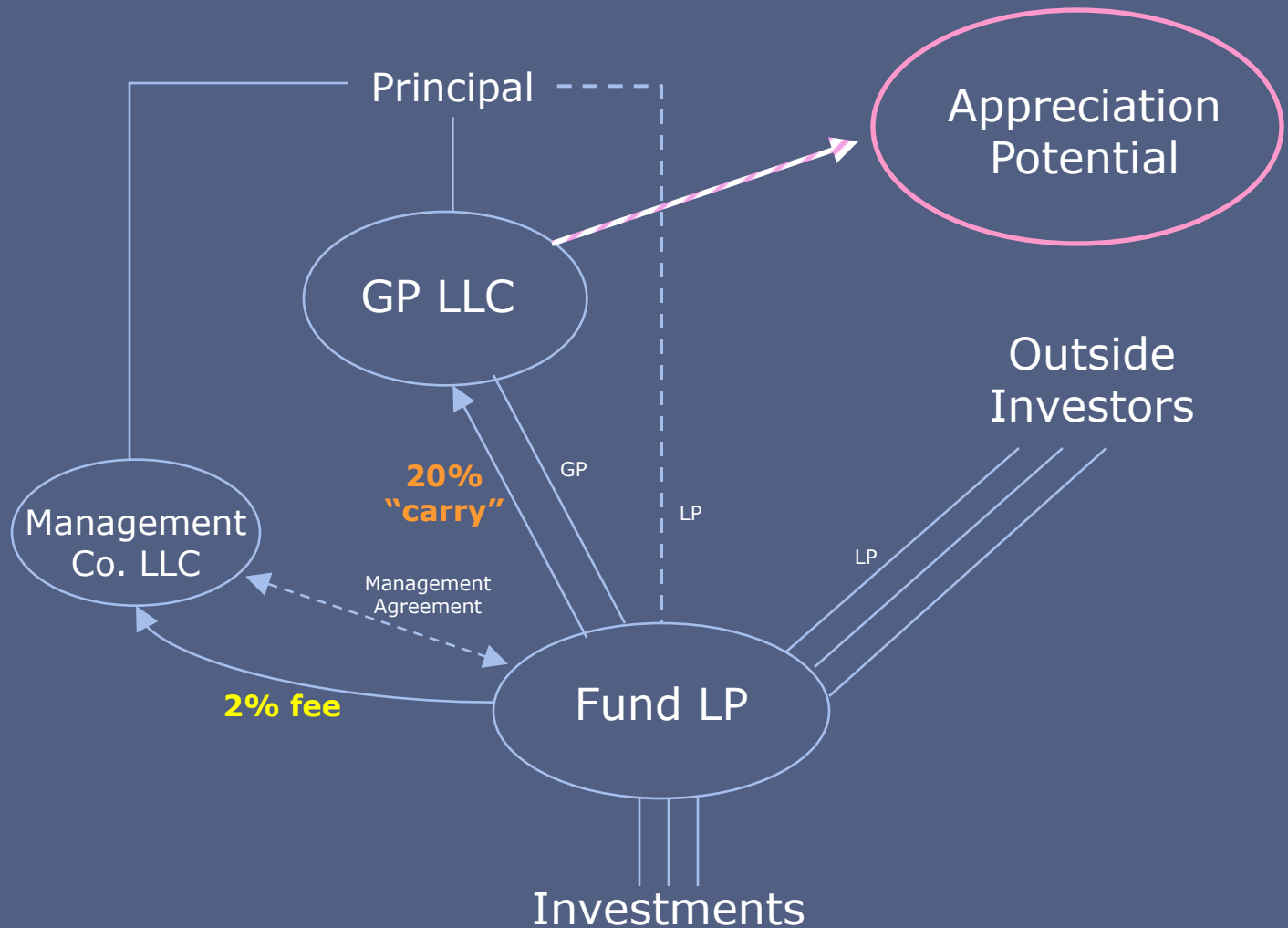
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Typical Fund Structure



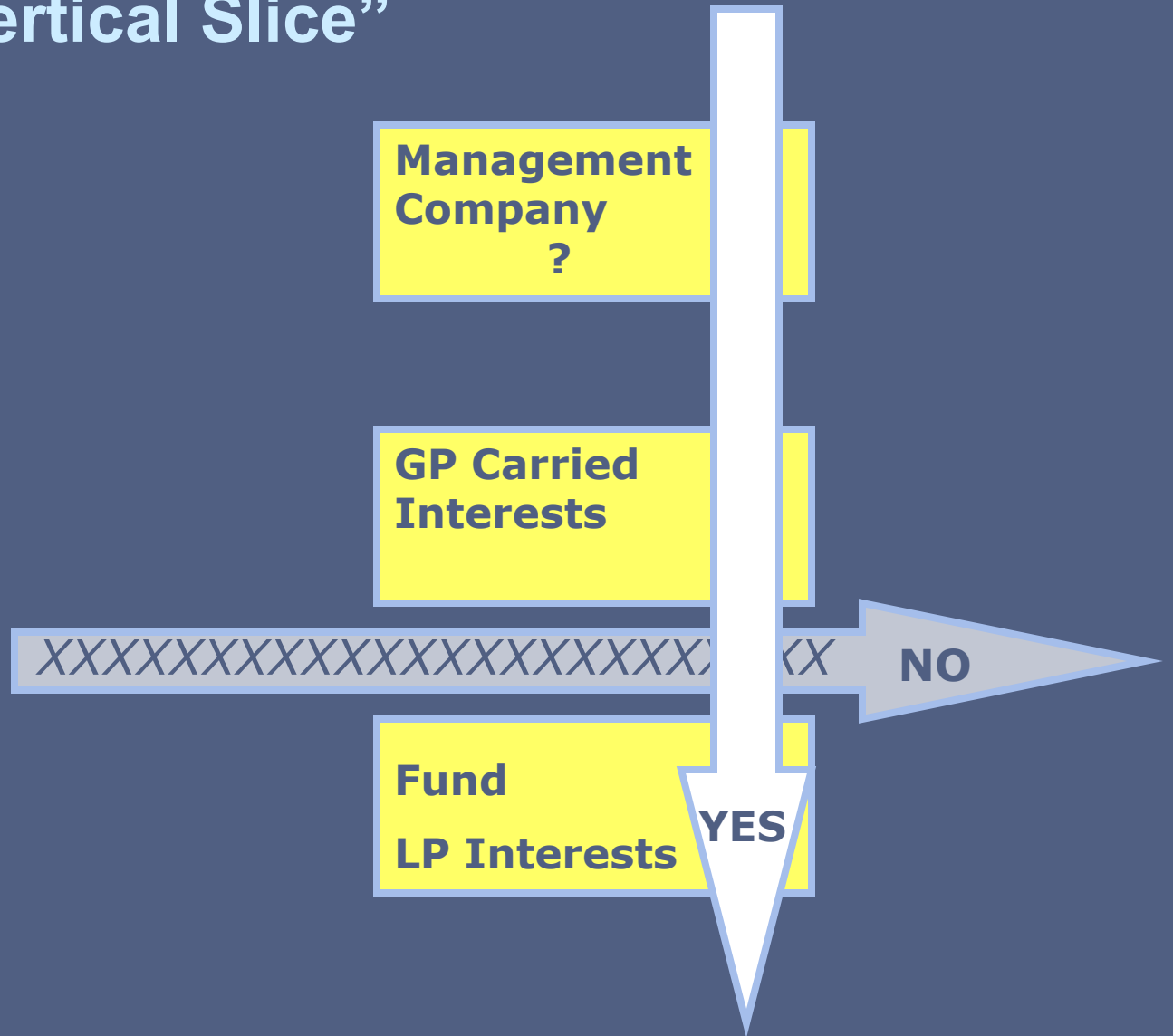


What is the “Vertical Slice *Rule*” and why do we care?

- The most elegant solution to a draconian deemed gift tax rule under IRC Section 2701
- The “rule” is really just one (of several) safe harbor exceptions to Section 2701
- Broadly requires a parent who wishes to transfer a percentage of his GP carried interest to children (or their trust) to also transfer a proportional interest of fund LP interest (e.g., 25% carry + 25% LP interest)

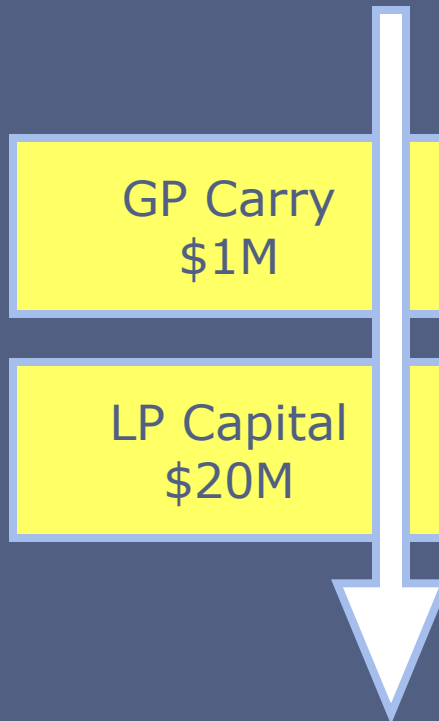


The “Vertical Slice”



Limitations on Vertical Slice Planning

Example



- If Parent makes a Vertical Slice gift of 50% of his \$1M GP interest (= \$500,000), he must also make a proportional gift of 50% of his \$20M LP capital (= \$10M). Total gift of \$10.5M x 35% gift tax rate = \$3.675M gift tax liability.
- This can be too restrictive when a partner has significant LP capital invested in the Fund.

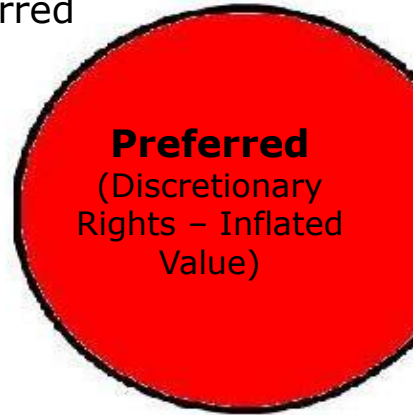
Pre-2701 Preferred Partnership Perceived Abuse



Pre-2701 Preferred Partnership Perceived Abuse

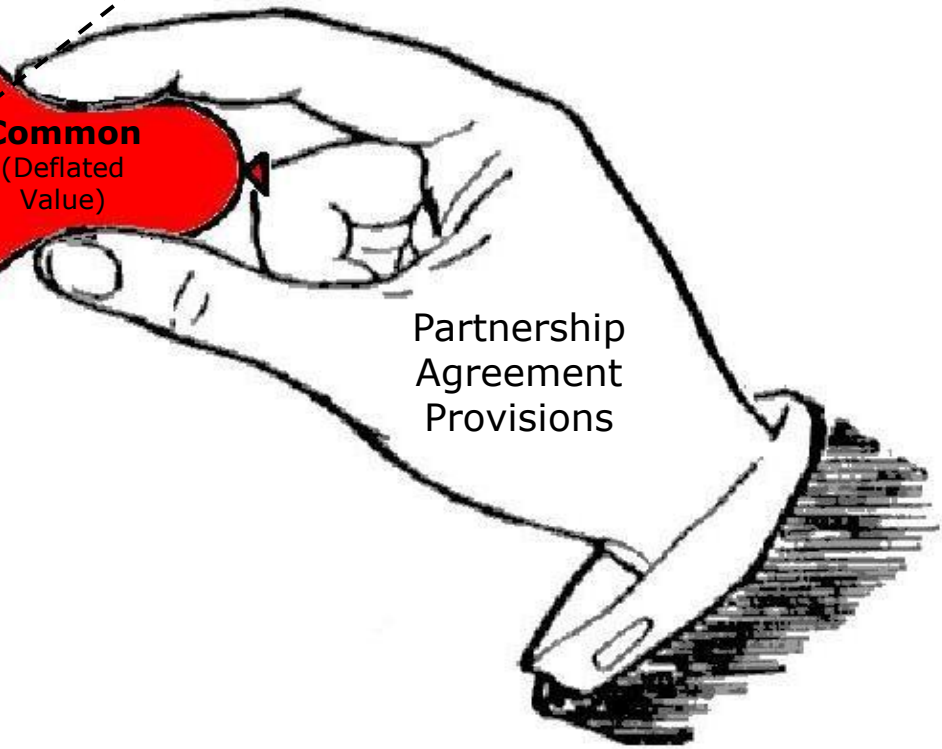
Valuation Before Gift

Parent
Retained
Preferred



Common
(Deflated
Value)

Common
Gifted to **Kids**
(at depressed value)

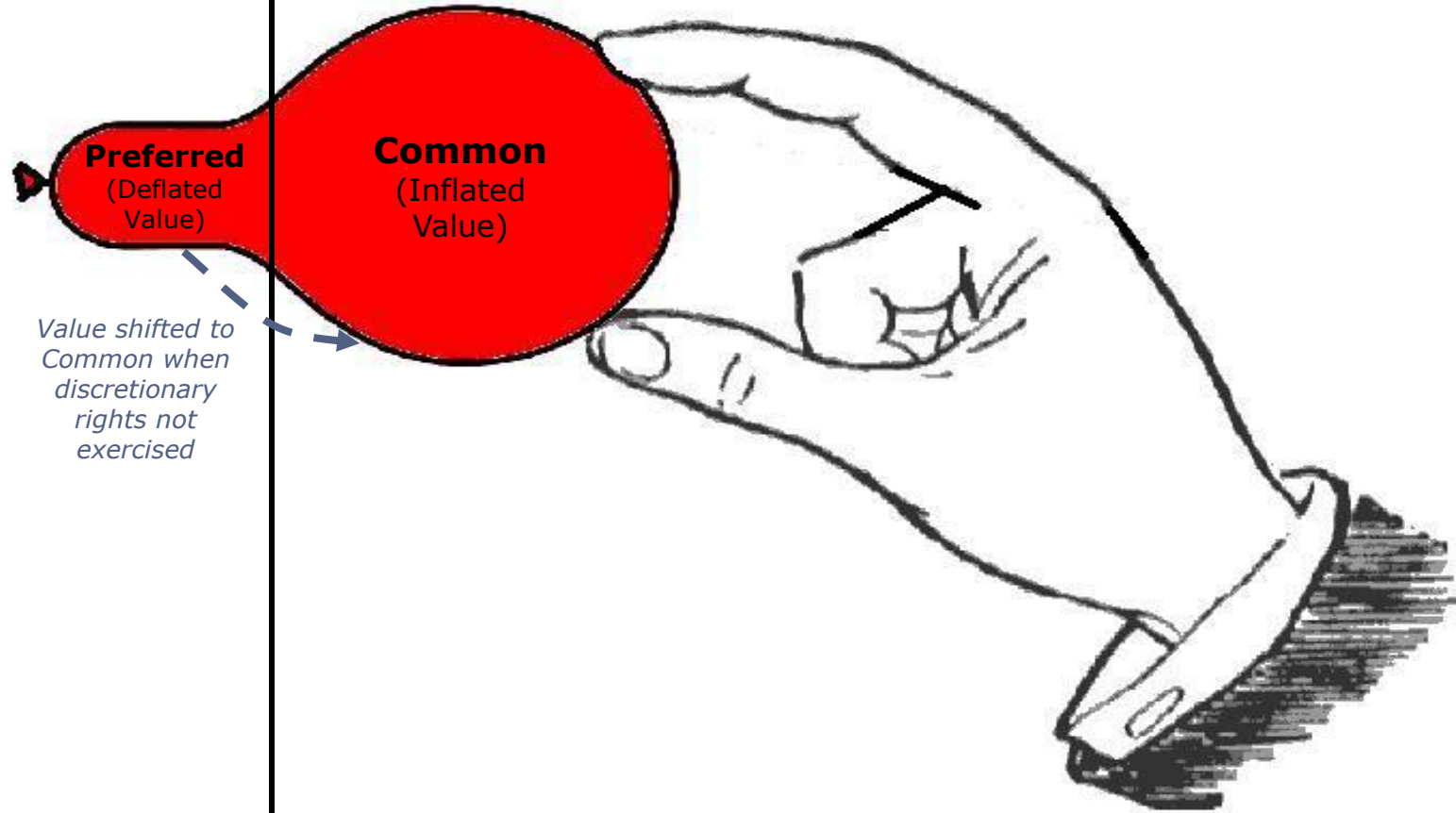


Partnership
Agreement
Provisions

Pre-2701 Preferred Partnership Perceived Abuse Valuation After Gift

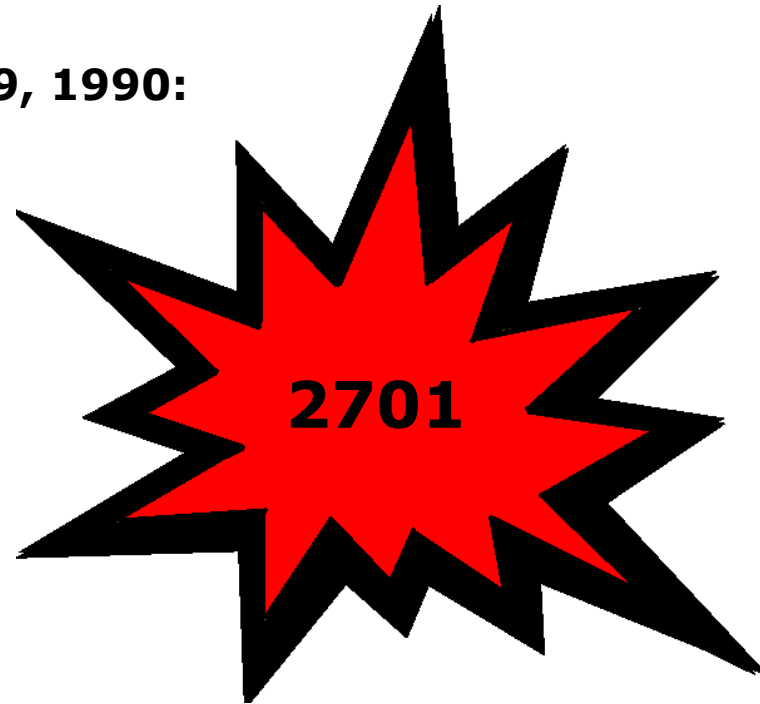
Parent

Kids



Pre-2701 Preferred Partnership Perceived Abuse

After October 9, 1990:

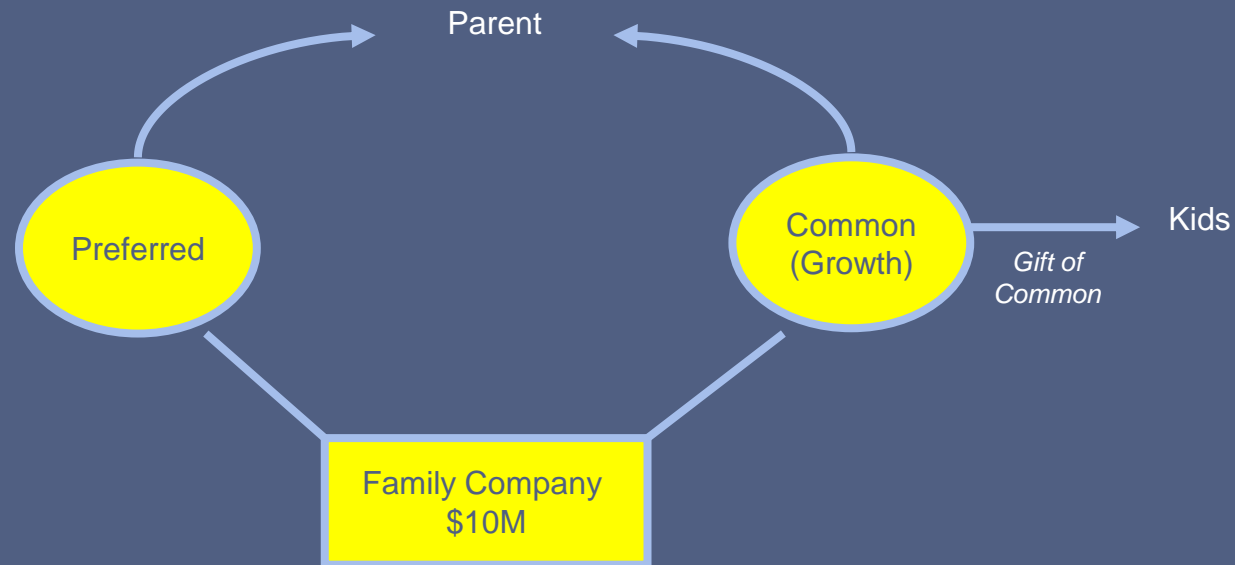


*Values Parent's Retained Interest at Zero, causing deemed gift



Basics of Section 2701

- Congressional response to perceived abuse
 - “Zero valuation rule” applied to Preferred Interests:



Pre-2701:

Value of Family Company	\$10M
Less: Artificially high value of preferred	<u>(\$ 9.5M)</u>
Gift Value of Common	\$500k

Post-2701:

Value of Family Company	\$10M
Less: “Zero” value of preferred	<u>(0)</u>
Gift Value of Common	\$10M

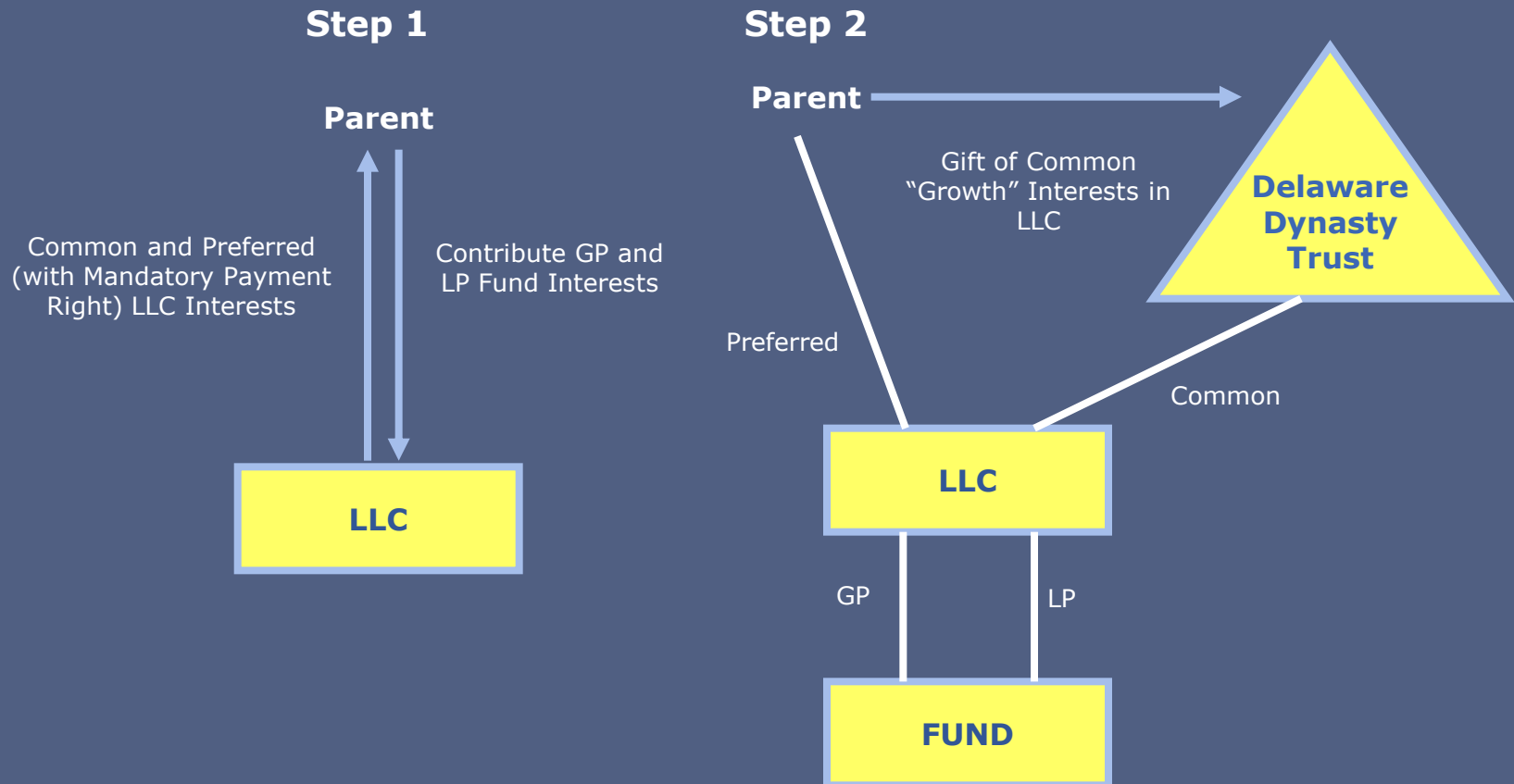


“Non-Vertical” Approaches

- Section 2701 was not designed to attack carried interest transfer transactions, but rather intra-family transactions involving wealth manipulation between different classes of equity.
- Overly broad and arcane rule resulted which can potentially catch transfers of carried interests in the gift tax net.
- When “Vertical” approaches are not appropriate, 2701 compliant “Non-Vertical” approaches should be considered
- Code and Regulations include other safe-harbors for certain mandatory and quantifiable rights

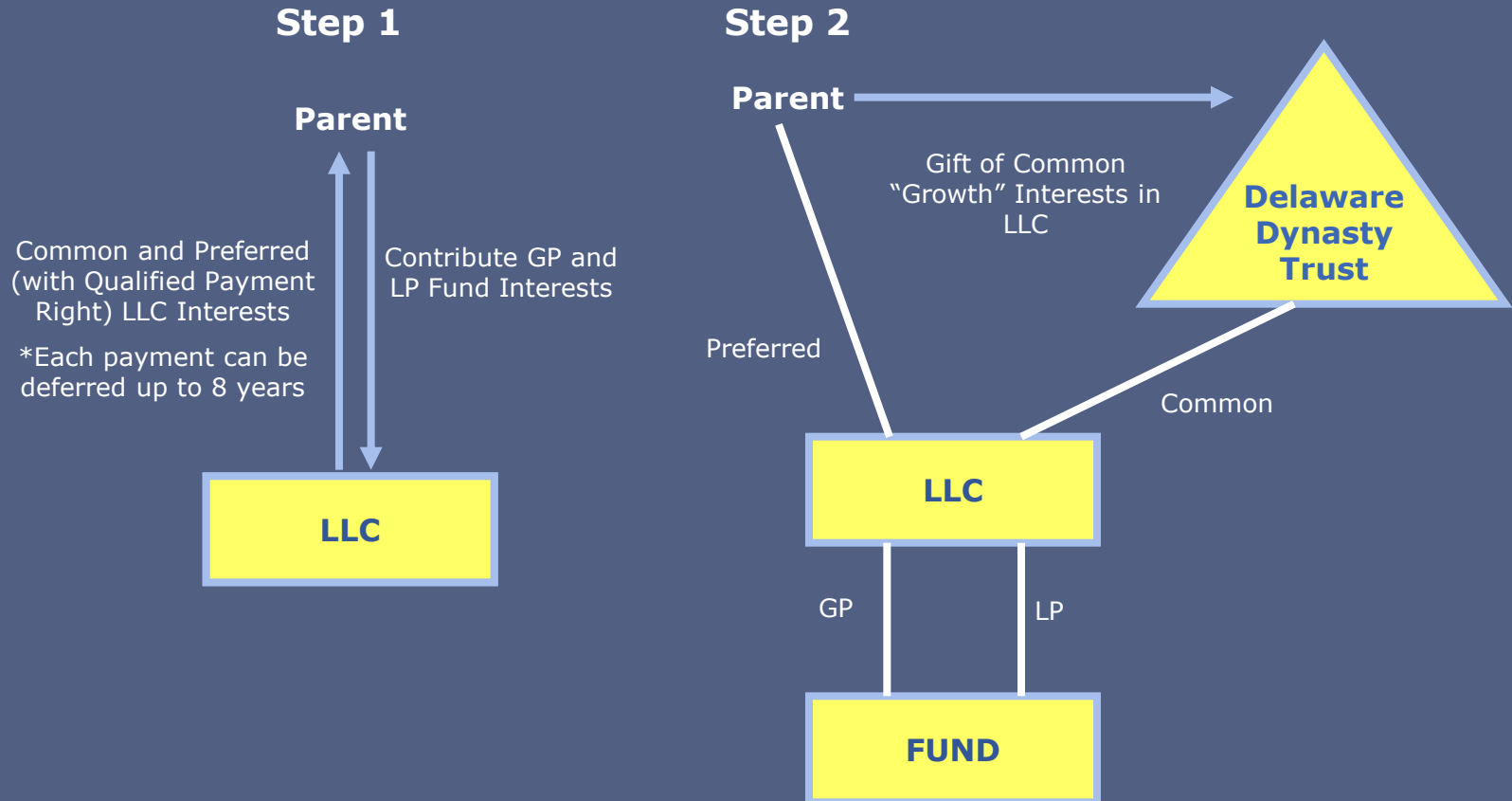
Holding Entity Approach #1

The parent's retained preferred interests include a mandatory payment right



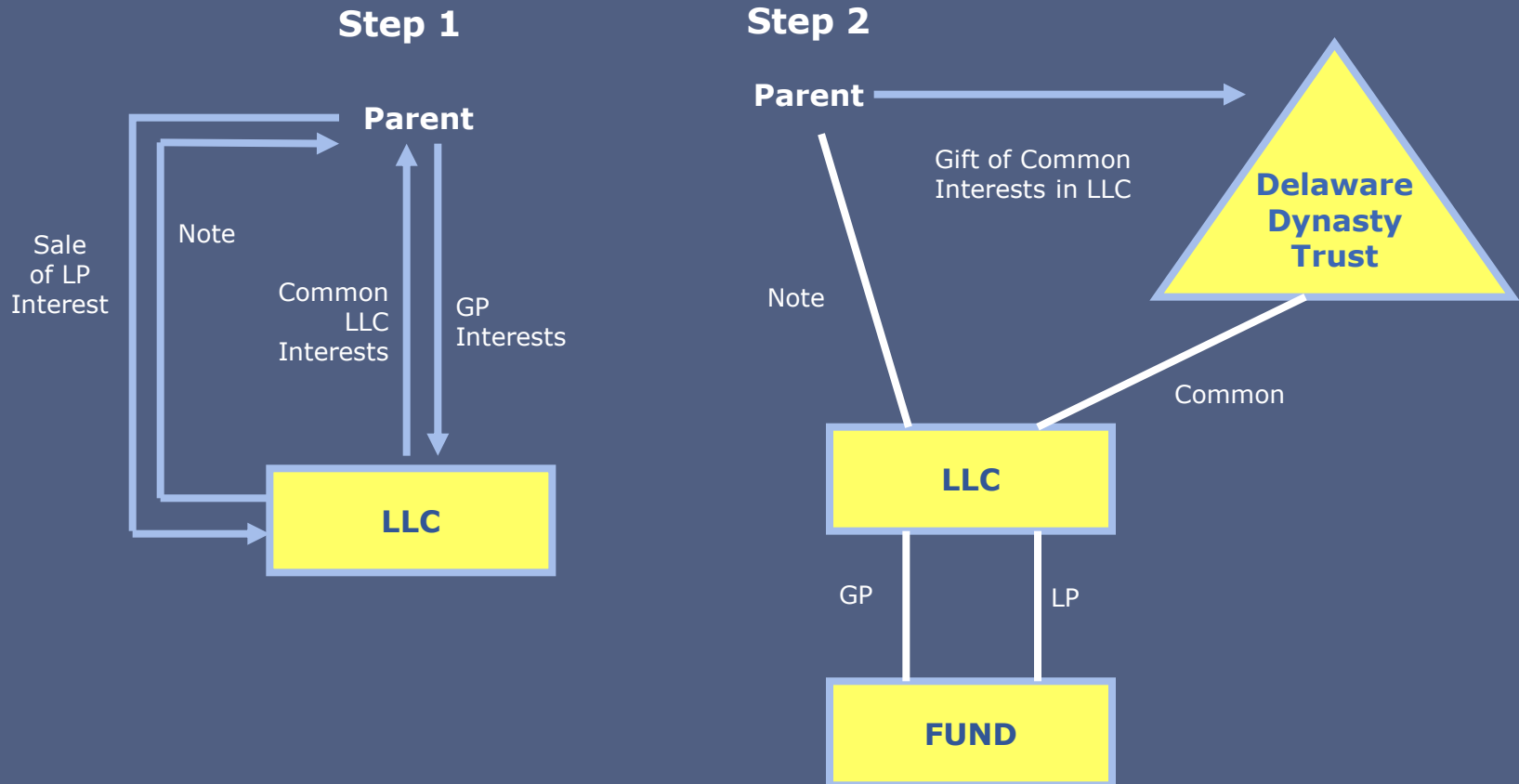
Holding Entity Approach #2

The retained preferred interest contains a qualified payment right



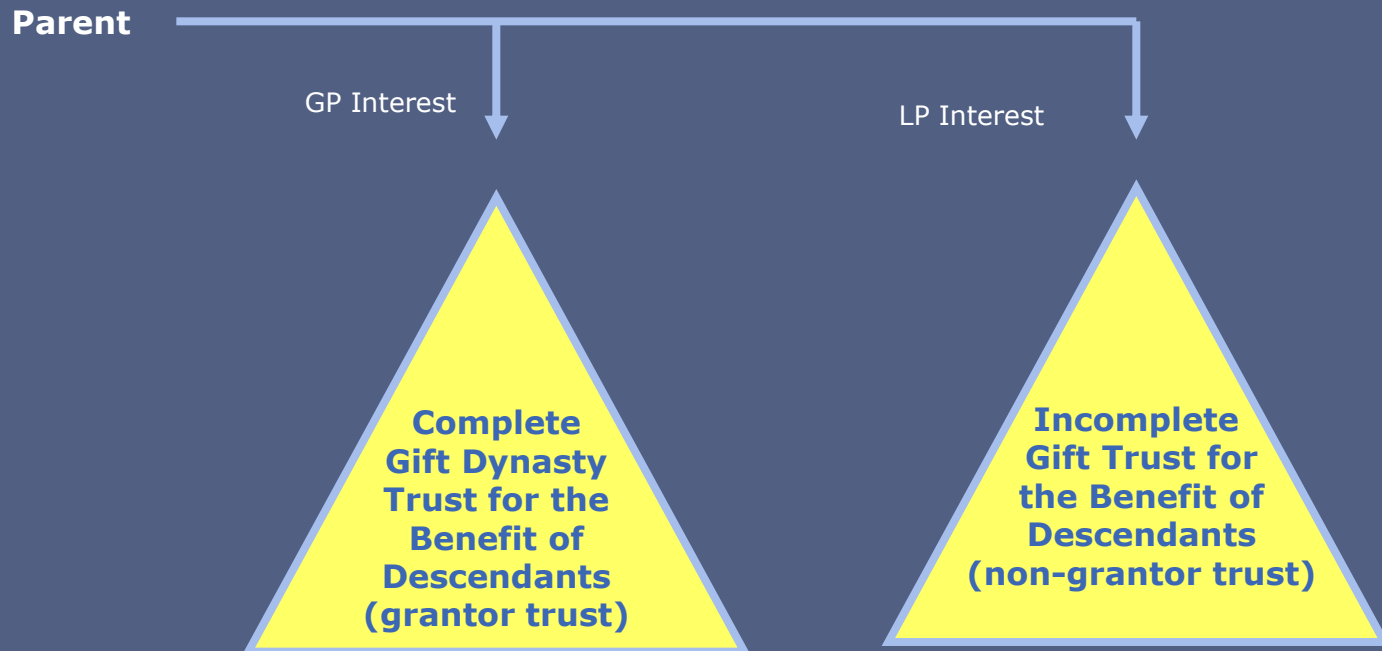
Holding Entity Approach #3

The parent sells the limited partner interests to the holding entity limited liability company in exchange for a promissory note



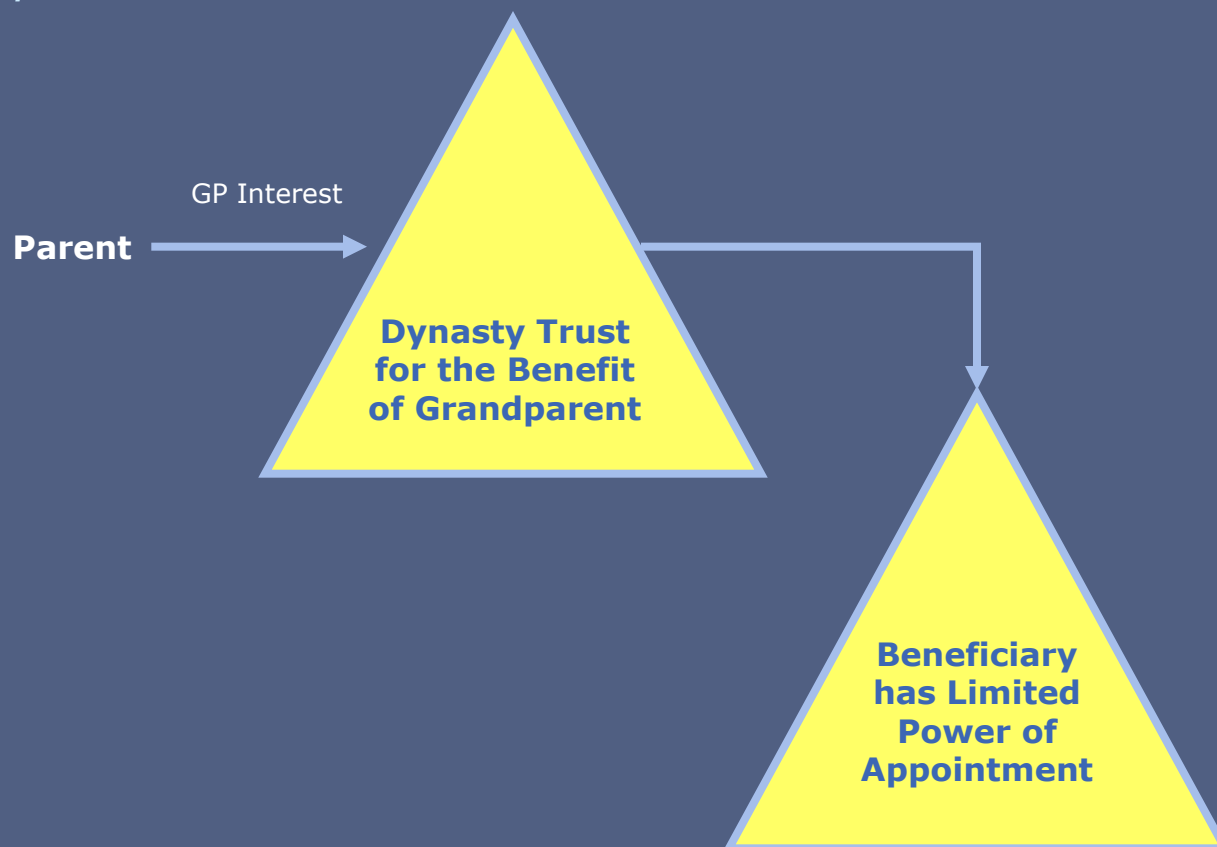
Parallel Trust Transfer

This approach involves the creation of side-by-side complete and incomplete gift trusts



Trust for Other Beneficiaries

The parent transfers all or some of his carried interest into an irrevocable trust created for the benefit of older generations with a limited power of appointment



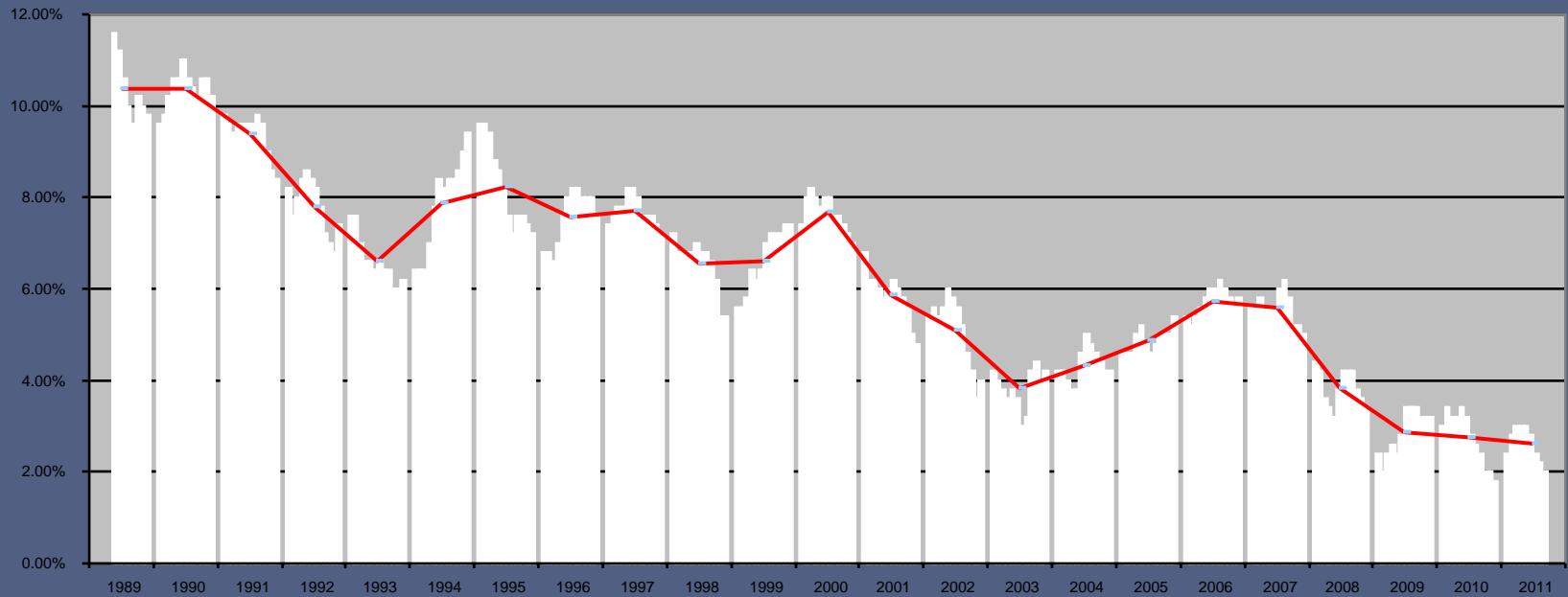


Low Interest Rate/Low Value Opportunity Planning

- “Estate Freeze” techniques work best when interest rates and/or values are low
- Estate and gift taxes (“transfer taxes”) are imposed based on the current value of an asset when it is transferred (i.e., at the time of gift or death)
- Appreciation after the transfer is generally not subject to transfer tax
- Undervalued assets with appreciation potential present a powerful planning opportunity
- Rates are at historic lows

Historically Low Interest Rates

Historical 7520 Rates



December 2009

Mid-Term AFR = 2.66%

7520 Rate = 3.4%

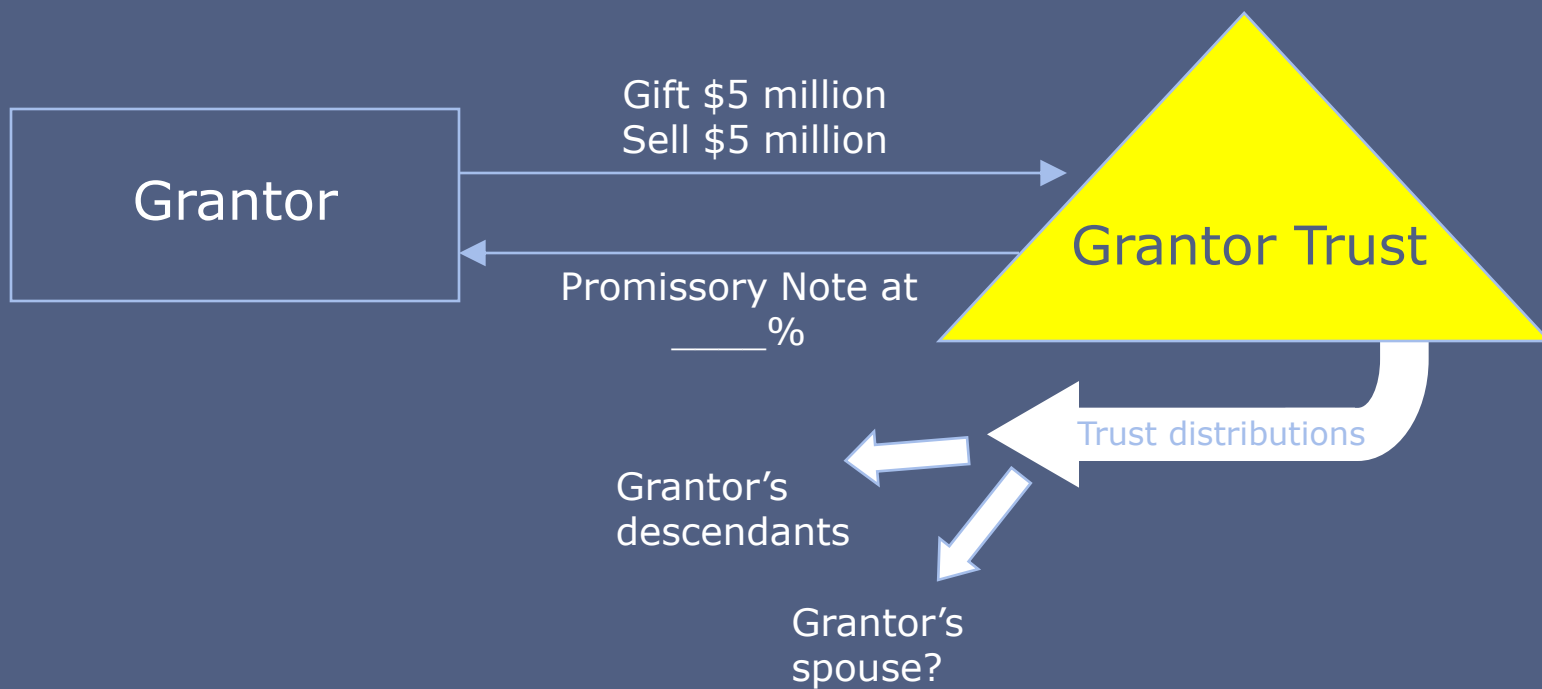
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Mid-Term AFR = ____%

7520 Rate = ____%

Yearly Ave.

Gift/Sale to Grantor Trust Illustration





Benefits of Gift and Sale to Grantor Trust

- Gift portion immediately shifts value out of grantor's taxable estate.
- Sale portion "freezes" grantor's estate at Note value plus interest, while Trust's assets grow outside of parent's estate.
- Grantor can pay trust income taxes, allowing Trust to grow tax-free.
- Sale does not trigger gain, and interest payments are not taxable.
- Trust assets protected from beneficiaries' creditors and divorcing spouses; Trust can continue in perpetuity.



Successfully Navigating Sophisticated Financial Solutions



ROBERT HARRISON

PARTNER

EISNERAMPER, LLP



**TAX - EFFICIENT
TRANSFER TECHNIQUES
FOR
CARRIED / PROFITS INTERESTS
(AND OTHER ASSETS)**

**Robert E. Harrison,
Tax Partner,
EisnerAmper LLP**

October 5, 2011

GRANTOR RETAINED ANNUITY TRUST (“GRAT”)

- PAYS GRANTOR AN ANNUITY FOR A TERM OF YEARS
- REMAINDER TRANSFERS TO NEXT GENERATION
- VALUE OF REMAINDER/GIFT CAN BE ZERO
- HURDLE IS IRS SECTION 7520 RATE (2 % FOR SEPTEMBER)
- HOW TO PAY THE ANNUITY
 - 3RD PARTY BORROWING
 - PAY WITH A PORTION OF ASSETS
(REQUIRES ANNUAL VALUATION)
- MUST SURVIVE THE TERM (MORTALITY RISK)
- REALLY NO TAX RISK

GRANTOR RETAINED ANNUITY TRUST ILLUSTRATION

Assumptions:

Initial Value:	500,000
Annual Annuity:	106,078
Number of Years:	5
IRS Interest Factor	2.0% (9/11)

Summary:

Amount Transferred to Children:	3,817,922
Amount of Taxable Gift:	Zero

<u>Year</u>	<u>Beginning Balance</u>	<u>Value of Carry in GRAT</u>	<u>Annuity to Grantor (a)</u>	<u>Value After Annuity Paid</u>	<u>Value of Total Carry</u>	<u>% of Total Carry Returned</u>
1	500,000	600,000	106,078	493,922	600,000	17.8%
2	493,922	822,000 (b)	106,078	715,922	1,000,000	10.6%
3	715,922	2,148,000 (c)	106,078	2,041,922	3,000,000	3.5%
4	2,041,922	2,724,000 (d)	106,078	2,617,922	4,000,000	2.7%
5	2,617,922	3,924,000 (e)	106,078	3,817,922	6,000,000	1.8%

(a) Paid by a return of percentage of carry

(b) \$1,000,000 X 82.9%

(c) \$3,000,000 X 71.6%

(d) \$4,000,000 X 68.1%

(e) \$6,000,000 X 65.4%

New Proposed GRAT Legislation

- 10 YEAR MINIMUM TERM (HIGHER MORTALITY RISK)
- REMAINDER MUST BE GREATER THAN ZERO (E.G., 10% GIFT)
 - ELIMINATION OF GIFT TAX-FREE “ZEROED-OUT” GRATs

Sale to Grantor Trust vs. GRAT

<u>Sale to Grantor Trust</u>	<u>GRAT</u>
Tax Treatment less certain *	Tax treatment more certain. Sanctioned under Internal Revenue Code.
“Seed” gift generally required	Nearly zero taxable gift possible (under current law)
Note payments may be amortized or structured as interest-only with balloon	Annuity payment to grantor must be fixed (but may structure to increase annually up to 20%)
Lower AFR Rate (1.53% for Sept. 2011) (Mid-term)	7250 Rate (120% of AFR) - 2.0% for Sept. 2011
Minor mortality risk	Major mortality risk
Multi-Generational Planning: Yes	Multi-Generational Planning: Very difficult
* <i>Valuation risk may still exist</i>	

FAMILY LIMITED PARTNERSHIP

- TRANSFER ASSET TO A FAMILY LIMITED PARTNERSHIP
- TRANSFER INTERESTS IN THE FAMILY LIMITED PARTNERSHIP TO NEXT GENERATION
- DISCOUNTS AVAILABLE
 - MINORITY INTEREST / LACK OF CONTROL
 - MARKETABILITY / LIQUIDITY
- CONTROL OF FAMILY LIMITED PARTNERSHIP SHOULD NOT BE RETAINED
 - POSSIBLE INCLUSION OF FULL UNDISCOUNTED VALUE OF ASSETS IN TRANSFEROR'S ESTATE
- SHOULD HAVE BONA FIDE BUSINESS PURPOSE (OTHER THAN TAX SAVINGS)
- SOMEWHAT COMPLEX AND RISKY
 - VALUATION
 - INCLUSION IN GRANTOR'S ESTATE
- ADHERE TO ALL FORMALITIES
 - NO COMINGLING OF ASSETS

USE OF DERIVATIVE INSTRUMENTS

MAY BE POSSIBLE TO:

- KEEP THE CARRIED INTEREST BUT TRANSFER A PORTION OF THE ECONOMIC BENEFIT WITHOUT A GIFT TAX (USE LESS EXEMPTION)
- AVOID VERTICAL SLICE ISSUES
- AVOID VESTING ISSUES
- AVOID TRANSFEREE HAVING TO MEET CAPITAL CALLS
- MITIGATE VALUATION RISKS
- CAUTION: IRS APPROVAL UNCERTAIN

EXAMPLE OF DERIVATIVE TECHNIQUE

ASSUME: VALUE OF CARRIED INTEREST IS \$1MILLION

OBJECT: TRANSFER A SIGNIFICANT PORTION OF EXPECTED APPRECIATION TO NEXT GENERATION IN A TAX EFFICIENT MANNER

STEP 1: CREATE A GRANTOR TRUST

STEP 2: TRANSFER CASH TO GRANTOR TRUST EQUAL TO THE VALUE OF THE DERIVATIVE INSTRUMENT (DETERMINED BY APPRAISAL)

STEP 3: ENTER INTO DERIVATIVE CONTRACT WITH THE GRANTOR TRUST

EXAMPLE: SIX YEARS FROM DATE HEREOF GRANTOR WILL PAY THE TRUST THE EXCESS OF (A) 60 PERCENT OF THE **SUM** OF ALL CASH DISTRIBUTIONS MADE BY FUND X WITH RESPECT TO THE GENERAL PARTNER'S CARRIED INTEREST AND THE THEN VALUE OF SAID CARRIED INTEREST OVER (B) \$700,000.

STEP 4: APPRAISAL OF THE RIGHT TO RECEIVE IN SIX YEARS.

STEP 5: TRUST PAYS GRANTOR THE APPRAISED VALUE OF THE DERIVATIVE INSTRUMENT (ASSUME \$500,000 FOR THIS EXAMPLE).

POTENTIAL RESULTS OF EXAMPLE

- IF VALUE OF CARRIED INTEREST TURNS OUT TO BE \$5 MILLION, TRUST FOR NEXT GENERATION GETS \$2,300,000
 - NO INCOME TAX TO TRUST
 - GRANTOR PAYS INCOME TAX
 - ONLY GIFT WAS THE \$500,000 PREMIUM (COVERED BY EXEMPTION)
- IF VALUE OF 60 PERCENT DOES NOT EXCEED \$700,000, TRUST GETS NOTHING
- IF GRANTOR DIES BEFORE, TRUST WILL PAY INCOME TAX ON EXCESS RECEIVED OVER \$500,000 PREMIUM
- TRUST IS NOT SUBJECT TO POTENTIAL CLAWBACK, BUT GRANTOR IS
- IF CARRIED INTEREST SUBJECT TO VESTING, TRUST GETS PAID EVEN IF THERE IS A FORFEITURE

CHARITABLE INTENTIONS

- GIVE A PORTION OF THE INTEREST TO CHARITY
 - COULD BE A FAMILY PRIVATE FOUNDATION
- AVOID TAX ON LONG-TERM CAPITAL GAIN
- NOW A HIGH END VALUATION IS DESIRABLE
- CHARITABLE REMAINDER TRUST
 - DELAY / AVOID TAXATION OF THE GAIN
 - CHARITABLE DEDUCTION FOR VALUE OF REMAINDER INTEREST

GOOD VALUATION IS ESSENTIAL

- VALUATION SHOULD BE OBTAINED BEFORE THE TRANSFER
- DON'T TRY TO SAVE THE COST OF A VALUATION REPORT
- CONTEMPORANEOUS VALUATION HAS MORE CREDIBILITY
- GIFT TAX RETURN SHOULD BE FILED
 - ADEQUATE DISCLOSURE
 - STATUTE OF LIMITATIONS
- WHAT ARE THE KEY VALUATION CONSIDERATIONS AND METHODOLOGIES?

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Successfully Navigating Sophisticated Financial Solutions



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Valuation of Private Equity and Hedge Fund Interests

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Key Value Considerations – PE & Hedge

- ◆ Managers of a fund are often the primary driver
 - Track record and reputation – raise \$30MM vs \$6B
 - Client relationships and investment capabilities
 - Compensation issue if startup
- ◆ AUM/Committed Capital – existing or new/expected
 - Is there a key institutional investor providing support?
- ◆ Expected returns on investment classes/strategies
 - What is management saying to investors
- ◆ Vintage year considerations
 - Outlook for types of investments expected to be made
 - Funding availability for strategies

Key Value Considerations - Terms

- ◆ Economic terms of documents
 - Fees, hurdles, allocations, expenses, etc.
- ◆ Volatility of investment strategy and existence of high water mark (primarily hedge funds) or hurdle rate
 - Risk to profits interest and carried interest
- ◆ Withdrawal provisions, if any (primarily hedge funds)
 - Historical inflows/outflows of cash in subject fund
 - Inflows/outflows of similar funds
 - Correlation to returns

Key Value Considerations - Terms

- ◆ Capital commitments of GPs and timing of calls (PE)
- ◆ Fee waivers if any related to interest valued
- ◆ Vesting issues...possible incomplete gift
- ◆ Other issues impacting returns to interest being valued

Valuation Methods

- ◆ Discounted Cash Flow
 - Applies to hedge fund or PE fund interests
 - Modeling based on economic structure of fund
 - Flexible in modifying assumptions over time
 - Only a “best estimate” projection

- ◆ DCF with Scenario or Monte Carlo Analysis
 - Scenario method incorporates wider range of outcomes
 - ▶ Subjective as to probability assignment and other factors
 - Monte Carlo simulations - various software packages
 - ▶ More difficult to explain/defend
 - ▶ Subjective in less obvious ways

- ◆ Note: Allows for calculation of IRRs for different investor groups as reasonableness check

Valuation Methods (cont'd)

- ◆ Option Method in Valuing Carry
 - Primarily for PE funds where defined investment horizons exist
 - Generally difficult to apply for hedge funds

- ◆ Capitalization of Cash Flow Method
 - Can be used for hedge funds with history to work with
 - Make adjustments to normalize income
 - Projected growth can be tricky without discreet assumptions

- ◆ Guideline Company Method
 - For valuing entire hedge and diversified alternative asset firms
 - Comps – Fortress, Blackstone and others (US and Europe) only recently public
 - Not directly useful for carried interests or profits interests alone

Turn to the DCF method

Pvt. Equity DCF – Key Inputs

- ◆ Essentially build a financial waterfall
- ◆ Amount of total committed capital
- ◆ % of committed capital expected to be called
- ◆ % of called capital expected to be invested
- ◆ Management fee %, structure & timing:
 - Are there different management fee percentages for different investor groups?
 - Are fees payable quarterly or annually, in advance or in arrears?
- ◆ Estimated net expenses paid by the fund, and timing

Pvt. Equity DCF – Key Inputs (cont.)

- ◆ Estimated timing and \$ amounts of capital calls
 - For initial investments
 - For follow-on investments in existing portfolio companies
- ◆ Estimated average gross exit multiple on portfolio investments
 - Likely differs for initial and follow-on investments
- ◆ Once fund cash flows are modeled, then allocate cash flows to different investor classes
 - LPs
 - Special LPs (if applicable)
 - GP capital account interest
 - GP carried interest

Pvt. Equity DCF – Reasonableness of Inputs

- ◆ Historical track record from prior funds can be used to assess reasonableness of expense assumptions...less useful on exit multiples
- ◆ Implied IRR for Portfolio Investments:
 - Given exit multiples and time to harvest, is implied IRR reasonable relative to available market data?
- ◆ Implied IRR for LPs – Are they reasonable?
 - Prior fund performance (may/may not be relevant)
 - Available private equity data (general and strategy specific, if available)
 - Standard equity market benchmarks
 - 8% hurdle rate in model
 - If not, revisit assumptions!

Pvt. Equity DCF – Discount Rates

- ◆ No specifically comparable benchmarks exist for carried interests
- ◆ Generally must make a subjective determination relative to available data, including:
 - Required returns for LP interests in private equity funds;
 - Average required returns associated with underlying portfolio investments based on
 - ▶ Available survey data
 - ▶ VC/private equity rates appropriate to stage of development associated with underlying portfolio companies
- ◆ Derivatives and other structures (FLP/Family LLC) need valuing separately

Pvt. Equity Values – Derivatives/Other

- ◆ Derivatives and other structures (FLP/Family LLC) need valuing separately
 - Derivatives valued as option on carried interest payments
 - Partnership or LLC interests holding these interests may need valuation reflecting lack of marketability of interests
- ◆ Loans to GP interest holders (family trusts, others not in company) so can make capital calls needs modeling into equation

Hedge Fund DCF Considerations

- ◆ What's being valued:
 - Profits interest, management company, holding co. interest
- ◆ Term of fund is open - consider terminal value
 - Management fee income
 - Profits interest income
- ◆ “High water mark” level and associated risk
- ◆ LPs/investors can withdraw at least annually after initial lock-up period, given required prior written notice
- ◆ Management fee structure may differ for investors
 - Investor agreeing to a longer lock-up period may benefit from lower applicable management fees
 - Sponsoring investors – entirely different structures

Hedge Fund DCF – Key Inputs

- ◆ AUM at the Valuation Date
- ◆ Annual growth in AUM due to new money/investors
- ◆ Annual redemptions as a % of AUM
- ◆ Annual distribution of income if any
- ◆ Annual gross returns on average AUM
- ◆ Existence of high water mark

Hedge Fund DCF – Key Inputs (cont.)

- ◆ Management's fee percentages, structure & timing
- ◆ Hurdle rate %, if applicable:
 - Does manager get a % of all profits, or only profits above a certain minimum annual return?
- ◆ Estimated annual fund expenses
- ◆ Other...

Hedge Fund DCF – Reasonableness of Inputs

- ◆ Estimated annual returns relative to history or strategy-specific hedge fund indices
- ◆ Estimated returns relative to equity market benchmarks
- ◆ Estimated new money, withdrawal and expense assumptions relative to history (when available)

Hedge Fund DCF – Discount Rates

- ◆ Profits interests - comparable benchmarks don't exist for these interests
- ◆ Management company interests
 - Alternative asset investment companies now traded publicly
 - Comparability may be suspect
 - Rates of return may be derived
- ◆ Generally must make a subjective determination relative to available data, including:
 - Hedge Fund Indices
 - ▶ Providers include HFRI, CFSB-Tremont
 - ▶ Returns are for LP interests
 - ▶ Strategy-specific information is available
 - ▶ Debate continues concerning biases that are embedded in the indices, which include: (1) survivorship bias; (2) reporting bias; (3) “back-fill” bias
 - Historical returns data for the fund, if available
 - ▶ Provides framework for LP investor expectations, despite standard warnings that “past performance is not indicative of future results”

Market Approaches – Comps and Transactions

- ◆ Comp Company/Transaction Valuation Metrics
 - Multiples of EBITDA
 - ▶ Most direct profit measure
 - ▶ Compensation for subject company can distort
 - Price to Revenue
 - ▶ Affords comparability for differing fee structures
 - Percentage of AUM
 - ▶ Least reliable except where regressed to profitability measures
 - Note: Many transactions may have earn outs which can make up a sizable portion of deal...distorting publicly reported data

Publicly Traded PE/Hedge Fund Managers

◆ Fortress Investment Group

- IPO in February 2007
- Private Equity and Credit Funds
- \$43.1 Billion in AUM

◆ Blackstone Group LP

- IPO in June 2007
- Mostly known as LBO fund managers
- \$124 Billion in AUM

◆ Och Ziff Capital Mgmt. Group

- IPO in November 2007
- Hedge Fund: Merger Arbitrage, Convertible Arbitrage, Restructuring
- \$27.8 Billion in AUM

◆ BlackRock

- IPO in October 1999
- Investment Management
- Acquired Barclay Global Investors
- \$3.6 Trillion in AUM

Publicly Traded PE/Hedge Fund Managers

- ◆ KKR & Co. LP
 - IPO in March 2010
 - Global Private Equity specializing in LBO
 - Traded on Euronet in Amsterdam Exchange in October 2009
 - \$61 Billion in AUM
- ◆ Apollo Global Mgmt. LLC
 - Private Equity: LBO and Distressed Securities
 - Class A Shares
 - \$80 Billion in AUM
- ◆ Others exist internationally but primarily hedge funds:
 - Man Group – EMG.L (\$69b)
 - RAB Capital – RAB (\$1.9b)

Reasonableness of Conclusions

- ◆ Comparable companies (if even so) only apply to much more significant sized entities with diversification across asset types
 - Not usable with carried or profits interest valuations
- ◆ The greater percentage of subject company's cash flows are derived by management fees on vary large P/E funds, the more relevant available public company data becomes
- ◆ Ultimately, the value must make economic sense in a “willing seller, willing buyer” marketplace

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Scott has over 20 years of experience in financial consulting and business valuations. He spent six years doing acquisitions, divestitures and special financings for PepsiCo and Marigold Enterprises, a boutique consulting & leveraged buyout firm. His background includes experience with Arthur Andersen & Co., where he managed equity, debt, warrant/option, NOL and intangible asset valuations, along with general financial consulting engagements.

He is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers; and a Chartered Financial Analyst (CFA). He has been and remains active in the American Society of Appraisers and has chaired/co-chaired an annual valuation conference in NYC for over 19 years.

Scott has valued a wide variety of publicly and privately-held companies for acquisitions, share repurchases, financial reporting, estate and gift tax reporting, recapitalizations, and general corporate planning and litigation purposes. He has extensive experience in valuing P/E and hedge fund company interests.

He coauthored a book, *Investing in Junk Bonds; Inside the High Yield Debt Market*, John Wiley & Sons, New York, New York, 1987 (including a Japanese translation published in 1988) and several articles on “junk” bonds.

He has testified in US Tax Court, Bankruptcy Court, Delaware Chancery Court, State Supreme Courts, and arbitration venues in the Northeast, South and Western states. Scott holds a bachelors degree in Business from the University of Minnesota and an MBA in finance from New York University’s Stern School.



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