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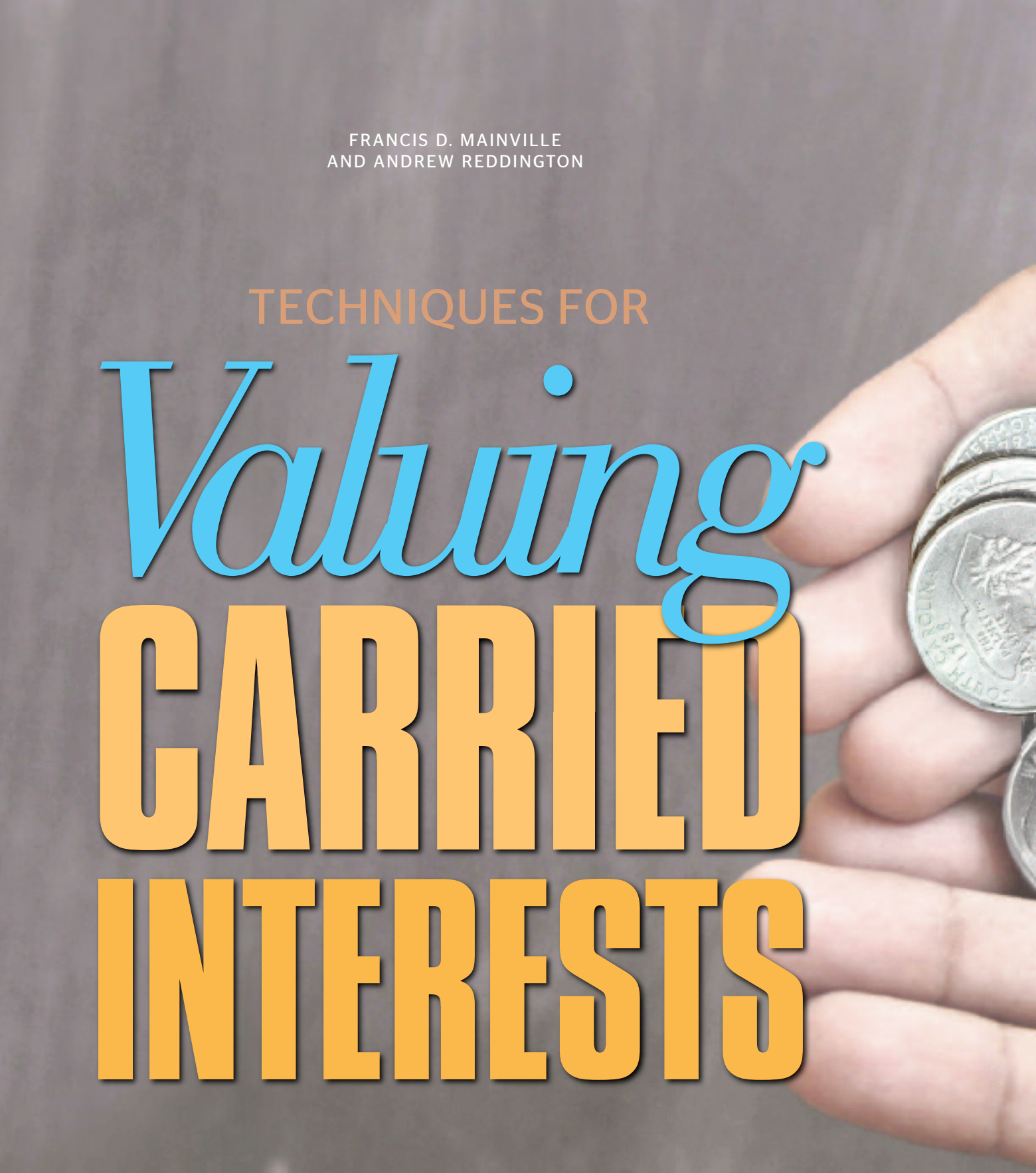
# TECHNIQUES FOR *Valuing* CARRIED INTERESTS



EACH CARRIED INTEREST HAS UNIQUE CHARACTERISTICS, INCLUDING HIGH RELATIVE VOLATILITY, AND TO BE DEFENSIBLE, VALUATIONS SHOULD BE SUPPORTED BY DOCUMENTATION AND MEANINGFUL DISCUSSIONS WITH THE CLIENT.


WASHINGTON
1869

# COMPARED TO MORE TRADITIONAL BUSINESS APPRAISAL ENGAGEMENTS,

valuing carried interests (also known as performance allocations) for gift and estate tax planning purposes[1] poses several unique challenges. Carried interests are defined as the right of a private investment fund's general partner to receive an economic benefit as compensation, independent of their contributed capital and above a limited partner return threshold. A common example is a right to 20% of the profits (above the return of limited partner capital).

In receiving value only if a threshold is met, carried interests have an asymmetric payoff similar to a stock option. By asymmetric, we mean the value of the carried interest as a percent of the total underlying fund value is not constant. For example, the value of the carried interest will be 0% of the underlying fund value if the return threshold is not met, while the percent will increase as the value over the return threshold increases. The carried interest shares in the upside of value in excess of the threshold, but does not suffer from any of the downside below the threshold.

## Standard of Value

For tax purposes the standard of value is fair market value (FMV) as defined under Rev. Rul. 59-60 and Reg. 25.2512-1, as follows:

> The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

In other words, in applying the standard of fair market value, appraisers are expected to assume that:

- The equivalent of *cash* is being paid for the subject being appraised as of the valuation date.
- The company (interest) being valued has been placed on the open market for a reasonable amount of time, enough for all potential purchasers to be aware of its availability.
- The hypothetical buyer is prudent but without synergistic benefit.
- A seller is not forced to sell (i.e., accept an offer that represents a "distress sale") and a buyer is not compelled to buy (i.e., necessary to earn a living).
- The business will continue as a going concern and not be liquidated.

Key aspects of these assumptions that are particularly relevant to carried interests include the concept that a seller is not forced to sell, and one would presume would not sell, the interest at a value that does not include the benefit that can be reasonably expected to be received over the holding period, and that the holding period is reasonable and appropriate given the expected life of the fund. This is consistent with the expectation noted above that the "business will continue as a going concern."

A well-grounded valuation analysis must also give consideration to the factors noted below in this discussion. As importantly, the valuation report must sufficiently document the background of the fund, the rights/economic benefit of the carried interest, how the valuation analysis considered the Rev. Rul. 59-60 factors, and most significantly, what the hypothetical buyer and seller could reasonably agree to be the expected benefit from owning the carried interest under consideration.

## Appraisal Process

To meet these requirements, the appraisal of carried interests typically involves the following steps:

- Information gathering. The appraiser will require information and legal documents that define the economic rights and obligations of the carried interest that enable the appraiser to develop a reasonable and supportable expectation of the benefit to be received by the owner.
- Selection of valuation methodology. An appropriate valuation methodology should be selected that captures the potential carried interest benefit and relies upon supportable data.
- Development of valuation assumptions. Forecasting the expected carried interest benefit involves a variety of assumptions including the distribution of future underlying investment values and the holding period of investments. The expected future benefits are then discounted back to the present at a

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discount rate appropriate for the valuation model applied and the risk characteristics of the carried interest. These assumptions can be difficult to support due to a general lack of directly comparable data and the difficulty in defining the risk of the carried interest.

- Development of a discount for lack of marketability. In general, the supportable discount for lack of marketability related to carried interests can be high, although the proper support for discounts can be challenging.
- Disclosure and documentation. Documentation in a valuation report that sufficiently reflects the disclosure requirements of the IRS and clearly presents the assumptions relied upon to arrive at the concluded fair market value. Proper documentation will allow a third party such as the IRS or relevant state department of revenue to replicate the report and understand the thought process behind the numbers.

## Information Gathering and Documentation

The information gathering process is critical to understanding the nature of the carried interest being valued and determining the appropriate valuation method(s) to apply. It is important for the client, the client's legal representative, and the appraiser to be on the same page regarding the scope of the valuation. For example, for funds in the middle stages of their life cycles, it is important to understand if the scope of the valuation includes the accrued carried interest from liquidated investments as opposed to a valuation that would only include the future expected carried interest from non-liquidated investments.

A typical information request will include legal documents such as the limited partner and general partner agreements, audited financial statements, fund information memorandums, past performance of the funds, and expectations regarding committed capital and capital draw downs. This information is critical to understanding the nature of the carried interest, the transfer restrictions, the expected timing of distributions, and the expected capital for investments. Each carried interest has unique characteristics and the proper documentation will assist in the replication of the analysis by a third party such as the IRS. A report supported by documentation and meaningful discussions with the client will provide a more defendable valuation conclusion.


## Valuation Method Selection

The selection of a valuation method is based on a combination of the nature of the carried interest and the information available. Appraisers should select a method that properly captures the features providing value to the carried interest while appreciating the information available to apply each method in a reasonable manner.

**Current vs. Forward-Looking.** A key consideration is the selection between a current value method and a forward-looking method. A current value method will determine the value of the carried interest as if all investments were liquidated as of the valuation date, while a forward-looking method will consider the future expected value to the carried interest based on assumptions regarding the future path of underlying asset prices. A forward-looking method will most often be the appropriate approach due to the asymmetric nature of carried interests. The asymmetry of the carried interest will also make it appropriate to consider a range of scenarios in a forward-looking model in order to capture the value of the carried interest across different asset values.

As an example of the difference of a current value method compared to a forward-looking method, consider a new fund that recently invested $100 million and a carried interest receiving 20% of profits over the $100 million threshold. Under a current value method, we would assume all investments are liquidated at the current value of $100 million and there would be no allocation to the carried interest. Under a forward-looking method, the expected appreciation of fund assets is modeled and the future carried interest value after appreciation is determined. The current value method would only be appropriate if there is a reasonable expectation of liquidation close to the valuation date. After all, the limited partners invest in the fund

"SHORTCUTS MAY EXPOSE THE CLIENT TO A REPORT THAT IS DIFFICULT TO DEFEND."

for the purpose of future expected appreciation and the carried interest receives a portion of the appreciation.

## The Income Approach

Of the three basic approaches to business valuation (income, market, and asset), the income approach should be relied on in the majority of carried interest valuations. The unique nature of each carried interest will usually make it difficult to find directly comparable market data to apply a pure market multiple approach, although market data is necessary to apply the income approach. The asset approach can be taken into consideration, especially if investments are marked to fair value in audited financial statements; but the asset approach will typically not appreciate the asymmetric nature of the carried interest.

Within the income approach the methods often relied on include discounted cash flow analysis, option pricing methods, and Monte Carlo simulation. A discounted cash flow analysis forecasts the expected cash flow to the carried interest and discounts these expected cash flows at a risk-adjusted discount rate. A discounted cash flow analysis can be applicable to a variety of situations, especially for funds such as real estate funds with expectations of significant interim cash flows. A multiple scenario discounted cash analysis is necessary to capture the asymmetric nature of the carried interest.

**Option Pricing Approaches.** An option pricing method such as the Black-Scholes option pricing model is often a relevant approach to consider. The advantages of an option pricing method include limited inputs that are easy to audit and the consideration of a wide range of possible scenarios in a closed form model. For example, a carried interest with a claim on 20% of the profits (gains in excess of investors' contributed capital) can be modeled as 20% of the value of a call option with an exercise price equal to the contributed capital.

**Monte Carlo Simulation.** A Monte Carlo simulation method relies on the simulation of thousands of iterations of a wide range of future scenarios. This method can be useful for very complex situations that are difficult to model with a discounted cash flow or option pricing method, but appraisers should use caution in using Monte Carlo simulation if a more simple method will reasonably capture the carried interest value.

## Assumptions

A forward-looking model requires assumptions regarding the expected range of the future benefit to the carried interest, the timing of the benefit, and the appropriate discount rate to calculate the present value of the expected benefit.

The carried interest benefit is directly correlated with the amount of funds invested and the returns on fund investments. The forecast of the expected carried interest benefit therefore begins with a forecast of expected liquidation values of the investments held by a fund. The valuation should consider capital that has already been drawn down as well as expected future capital drawdowns. Although future capital drawdowns are uncertain, the carried interest does benefit from these drawdowns and they would likely be considered by the hypothetical buyer and seller, with an appropriate risk factor added for the additional uncertainty relative to capital already drawn down.

**Expected Returns on Investments.** Considerations in the process of developing expected returns on investments will include past returns on those investments, general industry returns for similar investments, and the expected volatility of the investments. For example, for a carried interest in a venture capital fund, it may be appropriate to consider the past performance of funds under the same management team, long-term returns on venture capital investments in general, and the dispersion of future returns given the risk and volatility characteristics of venture capital investments. As stated earlier, the asymmetric nature of carried interests requires the consideration of a range of scenarios. Therefore, both the average expected investment return and dispersion from the average are important variables to consider. For example, a fund may expect the average investment to generate a return of two times the purchase price. However, the value of the carried interest may not be correctly estimated based on this average expectation, as investments returning greater than two times may have a disproportionate impact on the value of the carried interest relative to investments providing returns less than two times. A reasonable analysis, therefore, needs to consider the realization of scenarios above and below the expected average.

There are a large number of variables to consider in concluding upon a reasonable estimate of future investment returns; and reasonable assumptions will take into account the views of the hypothetical buyer and seller given the data available. After the future expected fund investment returns are determined, the resulting expected

"THE INCOME APPROACH SHOULD BE APPLIED IN THE MAJORITY OF CARRIED INTEREST VALUATIONS."

future carried interest benefit is typically a straightforward calculation in line with the distribution waterfall defined in legal agreements.

**Expected Timing.** The determination of the expected time to receive the carried interest benefit is based on a review of the legal documents, discussions with management, and an understanding of the fund investments. The legal documents will usually provide some guidance regarding when the carried interest can expect to receive distributions and the legal life of the fund. Discussions with management and an understanding of fund investments (i.e., stage in fund life cycle) can often provide valuable insights into expected timing that are not clear in the legal documents.

**High Discount Rates.** The nature of carried interests can justify relatively high discount rates.[2] The selection of a carried interest discount rate begins with an understanding of the expected return of underlying fund investments from available market information that is consistent with the information relied upon to develop expected investment returns. For example, the benchmark for a fund investing in large capitalization stocks may be expected returns for the S&P 500 index, while the benchmark for a venture capital fund will be higher due to the higher risk and higher historical returns of venture capital investments.

**Rate of Return.** After selecting an appropriate underlying investment rate of return, the appraiser can then begin the process of selecting a reasonable rate of return of the carried interest. This is often difficult due to the lack of direct market rates of required returns for carried interests. An appraiser must ultimately determine the risk of the carried interest relative to the underlying fund investments based on a variety of quantitative and qualitative factors. The uncertainty/volatility of returns and the required rate of return are closely related, with investors demanding high rates of return for investments with greater uncertainty of future returns. The asymmetric claims of carried interests can significantly increase the uncertainty of future expected returns, with the value of the carried interest being highly sensitive to changes in fund investment returns. Therefore, there is often a reasonable qualitative argument to rely on a high discount rate for the carried interest; while quantitative models that compare the expected volatility of the carried interest to the underlying fund investments can assist in substantiating a higher discount rate.

## Discount for Lack of Marketability

For tax valuations, appraisers should consider the IRS Job Aid relating to the discount for lack of marketability (DLOM).[3] The Job Aid considers a variety of factors to support a DLOM including restricted stock studies, interest-specific qualitative factors, and securities-based approaches (quantitative models) such as put-option pricing models. Specific factors that will have a large influence on the DLOM of a carried interest include the expected timing of distributions, expected volatility of the carried interest, and transfer restrictions.

The timing of expected distributions can vary widely between different types of investments and different funds. For example, hedge funds investing in liquid public investments can be expected to distribute the carried interest on an annual basis while it may take venture capital funds several years to realize a cash benefit from investments. Additionally, distribution policies vary widely between funds, with some funds distributing shortly after each investment liquidation while other funds have clawbacks that increase the time to distribution. When using quantitative models, appraisers should consider the same factors relied upon in the selection of the discount rate. The carried interest can often be expected to have high relative volatility and this factor will lead to higher implied DLOMs when using quantitative methods.

## Report Documentation

A defensible valuation report will provide the information necessary to meet IRS adequate disclosure requirements,[4] and provide the reader with a clear understanding of the methods and assumptions relied upon. Rev. Rul. 59-60 states that all relevant factors should be considered, including the following:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the investment management industry in particular.

1 The relevant statutory provisions fall under transfer or excise taxes in some states.

2 Note an option pricing methodology will typically not rely on a risk-adjusted discount rate, but will alternatively rely on the risk-free rate due to the "risk-neutral" assumption of the Black-Scholes option pricing model.

3 Job Aid for IRS Valuation Professionals, Discount for Lack of Marketability, 9/25/2009.

4 In compliance with the requirements of Reg. 301.6501(c)-1(f)(3),(4).

3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the business.
5. The dividend-paying capacity.
6. Whether or not the business has goodwill or other intangible value.
7. Prior sales of the stock and the size of the block to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business as the subject company and whose stocks are actively traded in a free and open market, either on an exchange or over-the-counter.

At a minimum, a report should have an industry overview, a background description of the fund and carried interest, and an explanation of the valuation analysis and the key assumptions relied upon to arrive at the concluded value. If the valuation report meets the adequate disclosure requirements, a safe harbor is created such that gifts are auditable by the IRS for only up to three years following the date of transfer.

## Conclusion

The transfer of carried interests can be appealing as a result of low supportable current values relative to potential future appreciation. Shortcuts such as relying on the current value method however may expose the client to a report that is difficult to defend from the perspective of the hypothetical buyer and seller. A defensible report will include adequate documentation of the information and factors considered, an appreciation of the unique nature of each carried interest, selection of a valuation methodology consistent with the nature of the carried interest, and supportable assumptions for key factors such as expected future returns, discount rates, and discounts for lack of marketability. ■